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THE REVENUE ACT OF 1938¹

BY GERHARD COLM

IN THE present economic stress and crisis . . . we wanted to do something if a tax could do it that might . . . give some impetus to this great and powerful and wonderful and resourceful country on the road to recovery," declared Senator Harrison in the Senate on May 28, 1938.

The Revenue Act of 1938 was drafted mainly with the intention of helping business to recover from the depression without impairing the revenue to be derived by the government. This study is designed to examine the arguments which contend that the act will help to restore recovery, especially to "facilitate the flow of capital into new enterprises, release frozen capital."² The analysis will be confined to two provisions: the revision of the treatment of capital gains and losses; and the taxation of corporate profits. It will not be primarily concerned with the probable fiscal productivity of the new tax provisions, or with their equity and long-run economic consequences. It is not intended to pass judgment on whether this tax revision, aside from its recovery implications, is good or bad. Such judgment would have to be based on a much more comprehensive study.

To expect this tax revision to "give some impetus to recovery" may mean two entirely different things. It may mean a belief that the tax revision in itself will bring about recovery, as certain pro-

¹ The background for this study is the analysis of the previous laws in Gerhard Colm and Fritz Lehmann, *Economic Consequences of Recent American Tax Policy*, Supplement I to *Social Research* (New York 1938), cited hereafter as Colm-Lehmann. There the economic implications and consequences of taxation, in both their long-run and their short-run aspects, are analyzed in greater detail than is possible in the present article. I am indebted to Dr. H. Benjamin for his assistance, and to Professors R. M. Haig and Carl Shoup for valuable comments on the manuscript.

² Senate Report, 75th Congress, 3rd Session, *Revenue Bill of 1938*, Report to accompany H.R. 9682 (April 5, 1938) p. 7.

ponents of the bill contend. "Witnesses by the score . . . have stated certain changes should be made with reference to capital-gains and undistributed-profits taxes, and certain surtaxes, if there is to be a revival of business activity, and that *if those changes are made it will cause a revival of business.*"¹ On the other hand, it may mean a belief that a recovery initiated by other factors has a better chance to last and to develop into prosperity under this tax law than it has had under the operation of the previous laws. This interpretation implies the opinion that the effects of taxes were among the causes which brought the last recovery to a premature end. I shall consider the probable effects of the new Revenue Act from both these points of view: first, that there are no stimuli working for recovery other than the provisions of this bill; second, that there are other forces contributing to recovery, as for instance the federal investment program.

Capital Gains and Losses

PRINCIPLES OF TAXATION

In the treatment of capital gains and losses the revised tax differs from the old in three important respects, which need be described only very briefly.²

First, in the Revenue Act of 1938, as in previous acts, short-term capital gains are treated as income and taxed according to the bracket to which the taxpayer belongs. In the laws prior to 1934 short-term capital transactions meant the sale of assets held for not more than two years; in the laws for 1934 to 1937 the period was one year or less, and in the new law it is eighteen months or less. Thus the sale of assets held over one year but not over eighteen months is now taxed more severely than before.

¹ The Chairman of the Senate Committee in Hearings before the Committee on Finance, U. S. Senate, 75th Congress, 3rd Session, *Revenue Act of 1938*, revised edition (March 1938) p. 697 (cited hereafter as Senate Hearings); italics mine.

² For a more comprehensive and detailed description of the act cf. *Federal Tax Law with Explanatory Digest, Revenue Act of 1938* (Prentice-Hall, New York, May 1938).

Second, on assets held more than two years individual taxpayers have now to include in their income declaration 50 per cent of capital gains, and on assets held between eighteen months and two years, 66⅔ per cent. On these long-term capital transactions, however, the taxpayer has the option of paying instead a flat rate of 15 per cent of the total gain on assets held more than two years, 20 per cent on assets held between eighteen months and two years. Thereby a ceiling is put on the progression, which stops now at about the \$50,000 net income bracket. Thus there is no longer a tax incentive to hold assets beyond two years. The law of 1934, which was in force until 1937, contained a step-scale ("aging") provision by which the tax on long-term gains decreased with the length of time the asset was held. The new law taxes at a uniform rate all gains from the sale of assets held more than two years, irrespective of the time the assets have been held. On gains from assets held between eighteen months and five years the new law means a reduction of the tax rate for taxpayers in all brackets. On gains from assets held more than five years it means a reduction only for the high income brackets (*cf.* Table 1 on following page).

Third, deduction for capital losses has been liberalized in some respects by the new law. Net short-term capital losses may now be carried over into the succeeding year, but short-term losses may no longer be deducted from long-term gains. The provision of the previous law which made it possible to deduct from other income a net capital loss up to \$2000 has been eliminated. The amount to be deducted for long-term capital losses is computed in the same way as in computing the tax for long-term capital gains.

The provision to allow the deduction of long-term capital losses will probably meet the fewest objections on grounds of principle; it is generally agreed that the principle of the capital gains tax requires full deductibility of losses. Under-Secretary Magill, for example, has declared, "There is a strong case for a

TABLE I
COMPARISON OF TAXES ON CAPITAL GAINS UNDER OLD AND NEW LAWS

Net income subject to normal and sur- tax before \$100 ad- ditional income ^a	Normal tax and surtax on \$100 addi- tional ordinary net income		Normal tax and surtax on \$100 capital gains from assets held for:											
	1938	1937	1 year or less		Over 1 year, but not over 18 months		Over 18 months, but not over 2 years		Over 2 years, but not over 5 years		Over 5 years, but not over 10 years		Over 10 years	
			1938	1937	1938	1937	1938	1937	1938	1937	1938	1937	1938	1937
\$5,000.....	\$8	\$8	\$8	\$6.40	\$5.33	\$6.40	\$4.00	\$4.80	\$4.00	\$3.20	\$4.00	\$2.40	\$4.00	\$2.40
10,000.....	11	11	11	8.80	7.33	8.80	5.50	6.60	5.50	4.40	5.50	3.30	5.50	3.30
20,000.....	19	19	19	15.20	12.67	15.20	9.50	11.40	9.50	7.60	9.50	5.70	9.50	5.70
30,000.....	23	23	23	18.40	15.33	18.40	11.50	13.80	11.50	9.20	11.50	6.90	11.50	6.90
40,000.....	28	28	28	22.40	18.66	22.40	14.00	16.80	14.00	11.20	14.00	8.40	14.00	8.40
50,000.....	35	35	35	28.00	20.00	28.00	15.00	21.00	15.00	14.00	15.00	10.50	15.00	10.50
60,000.....	39	39	39	31.20	20.00	31.20	15.00	23.40	15.00	15.60	15.00	11.70	15.00	11.70
70,000.....	47	47	47	37.60	20.00	37.60	15.00	28.20	15.00	18.80	15.00	14.10	15.00	14.10
80,000.....	55	55	55	44.00	20.00	44.00	15.00	33.00	15.00	22.00	15.00	16.50	15.00	16.50
90,000.....	59	59	59	47.20	20.00	47.20	15.00	35.40	15.00	23.60	15.00	17.70	15.00	17.70
100,000.....	62	62	62	49.60	20.00	49.60	15.00	37.20	15.00	24.80	15.00	18.60	15.00	18.60
500,000.....	74	74	74	59.20	20.00	59.20	15.00	44.40	15.00	29.60	15.00	22.20	15.00	22.20
1,000,000.....	77	77	77	61.60	20.00	61.20	15.00	46.20	15.00	30.80	15.00	23.10	15.00	23.10
2,000,000.....	78	78	78	62.40	20.00	62.40	15.00	46.80	15.00	31.20	15.00	23.40	15.00	23.40
5,000,000.....	79	79	79	63.20	20.00	63.20	15.00	47.40	15.00	31.60	15.00	23.70	15.00	23.70

^a Statutory income less exemptions and credits.

further liberalization of the provision for the deduction of losses."¹ The Under-Secretary continued, however, "Exactly how far an extension of the capital loss provision should go depends in large part on the revenue aspect of the problem."² It is not clear whether the provision concerning net long-term capital losses is still favorable to "the revenue aspect of the problem." It seems logical that a taxpayer who shares part of his gain with the government should be allowed to deduct his losses. If gains are regarded as income then losses must be a minus income, therefore deductible.

A difficulty arises, however, from the fact that a taxpayer is able to establish losses for the mere sake of minimizing his tax bill, without actually diminishing the value of his property by the transaction. If he shifts from stock A, which he bought at a higher price several years ago, to a similar stock B, which gives him the same chance of a later rise, he does not lose anything but he establishes a loss. This could be done also under the previous law, and probably was done to a certain extent. Under the previous law, however, the deduction was limited to \$2000 in excess of the capital gains realized in the same year. The new provision results in a reduction of the taxes to be paid on other current income. It seems to be very doubtful whether there is any possibility of preventing losses from being established for the mere sake of minimizing the tax bill.

The main points of the tax revision are that capital gains are taxed at what is in effect a lower rate than that for other income, and that progression in the taxation of capital gains stops earlier than progression in the taxation of other income.

Analysis of the taxation of capital gains faces the difficulty that this legal concept covers phenomena of quite different economic characters. Capital gains can be only another way of realizing a yield from capital investments (the investor has a choice between securities from which he can expect more current revenue and

¹ Senate Hearings, p. 679; cf. also Carl Shoup et al., *Facing the Tax Problem* (Twentieth Century Fund, New York 1937).

² Senate Hearings, *ibid.*

transactions from which he expects capital gains). Capital gains can also result from the realization of "unearned increments" in the strict meaning of the term. Finally, net gains can be a compensation for a special "risk bearing" in business financing. But a tax revision designed to induce capitalists to offer "hazardous" capital for new business financing may bring advantages also to those who speculate in existing securities or to those who realize "unearned increment."

It is not possible to discuss in this article whether it would be feasible to supplement the federal and state income taxes by special state or local taxes aiming at the "unearned increment." Opinion on the capital gains tax revision depends also on how successful the attempt will be to prevent an "improper accumulation of surplus" by corporations. The following discussion is confined to capital gains from transactions in securities—which provide the greatest proportion of all gains—and special attention will be paid to capital gains as a premium on "risk bearing" investments, because equalization of the tax burden imposed on the investor in values of assured return and of the burden imposed on the investor who is ready to bear a risk can be regarded as one of the objectives of the tax revision. The principle that realized capital gains are to be regarded as income will not be discussed, for it is the basis of the earlier as well as of the present tax law.

There are three possible reasons that might justify the lower rates provided in the new law. First, the need of an adequate allowance for the gradualism of appreciation. The usual argument for a special treatment of capital gains is that a profitable sale of capital assets means that an appreciation which possibly took place over a period of years is realized in one year. If the full income tax rate were applied to such gains the taxpayer would reach a higher tax bracket than the one to which he would have belonged if the tax had been computed on an annual accrual basis. The "aging" provision of the Revenue Act of 1934 took cognizance of this possible inequity. If the "aging" provision had an unde-

sired economic effect it was justifiable to substitute a generally lower rate for the previous step-scale scheme. In the present law, however, the tax rates for gains in assets held over eighteen months are scaled down much more than could be justified by the gradualism of the appreciation. Therefore this argument contains only a partial justification for the lower rates.

Second, fiscal considerations might have justified lower rates. If deductibility of losses is limited for fiscal reasons a lower tax rate could be justified as a compensation. For even if high tax rates and full deductibility of losses should, over a long period of time, provide as much revenue as lower tax rates and limited deductibility, the latter procedure would nevertheless provide a more steady revenue. The present tax bill, however, allows such a generous deduction for long-term losses that the lowering of rates can hardly be justified on this ground.

Third, from a fiscal point of view the main argument for lower rates is that the previous tax was almost prohibitive for the short-term and middle-term transactions of taxpayers in the highest brackets. Progressive tax rates usually stop at a certain maximum, lest they become confiscatory and prohibitive. The point where progression becomes prohibitive is not the same for taxation of current income and taxation of capital gains. No one will waive an opportunity to earn \$200,000 current income because he must pay \$100,000 to the government and can keep only \$100,000 for himself. But a tax of 50 per cent on capital gains may restrain many persons from selling a stock and induce them to keep it as a permanent investment. From a fiscal point of view it is therefore essential that progression in taxation of capital gains stop earlier than progression in taxation of current income. Not by a theoretical analysis but only by trial and error can we find where progression begins to be prohibitive.¹

¹ In regard to further legislation it would be very important for the statistics of income to analyze capital gains in greater detail. It is desirable, for instance, not only to have statistics on net capital gains and losses, but also to have gains and losses separately computed.

Nevertheless the fiscal argument could be waived in favor of a superior economic or social goal. If the previous tax did not produce the highest possible revenue it certainly restrained wealthy persons from accumulating more wealth through speculation. Thus the previous tax might have been justified not as a fiscal measure but as a measure of economic and social reform. Here arises, however, the question as to whether restraint of such speculation might not have undesirable repercussions. What function is played in economic development by the speculative transactions of wealthy persons? Is this function still needed or is it today fulfilled by other agencies? If this function is still needed for recovery the further question must be asked whether revision of the capital gains tax is a feasible instrument for inducing wealthy persons to embark again on hazardous ventures.

PROBABLE INFLUENCE ON THE ATTITUDE OF INVESTORS

Short-run speculation will probably not be substantially affected by this tax revision. The extension of the short-run period from twelve to eighteen months will restrict such speculation more than before, but even under the former law short-run speculation played a small role in transactions of those in higher brackets.

Thus short-run transactions depend predominantly on the activities of those in the middle tax brackets. In 1934, the only year for which such statistics are available, taxpayers of the net income brackets between \$5,000 and \$25,000 derived 40 per cent of their realized capital gains from assets held one year or less, 60 per cent from assets held two years or less, while taxpayers with a net income of \$100,000 or more derived but 14 per cent of their capital gains from assets held one year or less, and 22 per cent from assets held two years or less.¹ From all gains de-

¹On the basis of statistics compiled by the Treasury. Cf. Hearings before the Committee on Ways and Means, House of Representatives, 75th Congress, 3rd Session, *Revision of Revenue Laws 1938* (January 1938) pp. 115 and 119; this document is cited hereafter as House Hearings. The preliminary statistics for 1935 and 1936 (*ibid.*, p. 119, Exhibit 6a) indicate that within the various income classes the relative share of short-term and long-term gains changed little in comparison with 1934.

rived from sales of assets held two years or less 68 per cent were reported by taxpayers belonging to the income groups below \$25,000, while these same groups owned but 55 per cent of all stocks in the hands of taxable individuals.

The provision which allows a short-term net capital loss to be carried over to the succeeding year may stimulate short-term speculation in specific periods. Persons who report such a net loss for 1938 have, so to speak, a tax credit for use in case they make a short-term net gain in 1939. If they make no use of it in 1939 this tax credit will be forfeited. The desire not to waive any possible tax privilege may stimulate speculative activities on the part of persons who would otherwise have held their funds liquid. But not too much should be expected from these activities, because investors will never know whether an expected increase in market prices will occur soon enough to allow them to realize their gains no later than the year following the one in which losses were taken. If market prices increase, this provision may induce speculators to realize their gains more quickly than they would have otherwise.

The great difference between the tax rates for short-term and long-term transactions may have some slight importance in stimulating buying. Speculators who liquidated during the downswing may start to buy again, as soon as they believe that the trough of the depression has been reached, in order to get an early "birthdate" for their holdings. Thereby they increase the chance of realizing their prospective gains at the peak without paying the heavy tax for short-run transactions.

In general it must be concluded, however, that the revision of the capital gains provisions will not effect short-run speculation to a larger extent than did the previous law.

Also for a second type of investments the tax revision will not be of major importance: that is, for investments which have not from the outset been intended for early realization. The extreme case is the capitalist who invests to establish a relative in business or to test a promising patent or some other idea. Many develop-

ments which are today important were started in such a way. The significance of such promotion is diminishing because at present existing corporations are promoting most of the new ideas that appear promising. Yet such ventures are still financed by individuals, and probably there would be more of them if more capital were available for such purposes. The investor in new enterprises must be content with the fact that their stock will not be sold to the public for a number of years. The time from the start of a new venture until stock can be sold to the public is usually at least four years, and often much longer.¹ It is true that such new enterprises have frequently sold out to larger corporations, but this cannot be foreseen by the investor at the time of his initial investment. For this type of investment, therefore, the tax revision will hardly have any great effect.

There is probably a group of capitalists somewhere between those interested in short-term transactions and those investors who wait for a gain in a distant future. To this group belong investors who buy when a promising opportunity is offered them. They do not intend to make money on short-pull transactions, but when new occasions arise they wish to sell and change. They do not want to be tied up by tax considerations. It is this group of investors for whom the revision in the capital gains tax may be of real importance, for substantial gains might be derived from the sale of assets held between two and five years. In 1934, the only year for which adequate statistics are available, no group of taxpayers existed for which profits on such middle-term speculation played any role. Only 7 per cent of all reported gains were

¹ Examination has been made of the "age" of those corporations whose applications for initial listing of their stocks on the New York Curb Exchange were approved between April 1937 and April 1938. Of 76 corporations 21 were organized less than one year before the approval, 4 more than one but less than four years, 18 more than four but less than ten years, 20 more than ten but less than twenty years, 13 more than twenty years. The 25 corporations which were organized less than four years before the approval existed in another form before incorporation. It seems that in only two cases were stocks approved for enterprises which did not operate for a period longer than four years. (These data were compiled by Dr. F. Joseph.)

derived from assets held between two and five years.¹ Therefore such a group can be spoken of only as a potentiality. The question is how its virtual disappearance has affected economic development, and whether the tax revision may induce people again to engage in such investments for middle-term appreciation.²

It cannot be expected that the tax revision will induce many persons in the net income brackets between \$5,000 and \$50,000 to engage in middle-term transactions, but it seems reasonable to expect that those in the highest brackets can be influenced by the tax revision. The latter group has had a very small turnover of its assets (measured in relation to stockholdings) and most of its gains have been from assets held more than ten years, for which the law of 1934 provided the lowest rate. The lowering of the tax rate and the abandonment of the "aging" provisions may induce these investors to embark again on middle-term transactions.

It could be objected that a change in the attitude of this group of wealthy investors cannot be of great importance. It is, of course, impossible to say how many taxpayers belong among these potential investors for middle-term appreciation who might be influenced by the tax revision. Many of the wealthiest do not engage in such speculative investments, for reasons which have nothing whatever to do with taxation. Often persons in the same income bracket are tax-conscious to an entirely different degree. It is possible only to indicate the number and the saving capacity of those taxpayers who belong to income brackets for which the tax revision might be of major importance.

¹ This extremely low percentage may have been partly due to the fact that few stocks were bought between 1929 and 1932 which could be sold at a gain in 1934. But this cannot be the only explanation. While the percentage of gains from assets held between two and five years was 7 per cent for all taxpayers, it was 9.2 per cent for those in income brackets below \$25,000 and 0.3 per cent for those in brackets over \$100,000. These figures support the opinion that the capital gains tax of the Revenue Act of 1934 was practically prohibitive for this type of speculation by those in the highest brackets.

² That such a group existed before cannot be proved by statistics but is regarded as a fact by competent observers.

There are about 6000 taxpayers in net income brackets over \$100,000; their saving capacity (after deducting for taxes on current income, and also for a proportional fraction of estate taxes) is probably about 500 million dollars. The total saving capacity of the approximately 20,000 taxpayers with net incomes of \$50,000 and more will hardly amount to more than a billion dollars.¹ Even if the revision induced all those in high brackets to change their saving habits it could not be expected that more than a fraction of their current savings would be offered for the purchase of new securities. Thus not a very spectacular effect can be expected if only a rechanneling of current savings is considered.

The tax revision might be expected to have a greater immediate effect if it could be assumed that the wealthier persons will be induced to reinvest funds that have previously been held as deposits or in other liquid form. No estimate of deposits held by individuals is available,² but observers concur in the opinion that investors are holding quite substantial liquid amounts at the present time. They may be expected to enter the stock market again when they believe that the upward movement is coming, and the tax revision may strengthen their readiness to do so.

It may well be that in the future wealthy individuals will prefer speculative stocks rather than investments for revenue. The new tax law gives an incentive for taxpayers in the high brackets to realize their income in the form of capital gains rather than in the form of current dividends. Such an incentive existed under the previous law but it has been greatly strengthened. Also the virtual abolition of the undistributed profits tax may increase opportunities for investment in corporations which reinvest most of their profits.³

¹ These estimates are based on statistics for 1930; for the method used in making the estimates *cf.* Colm-Lehmann, Appendix A.

² Currie's valuable classification of deposits refers to 1935 as the latest date, and includes in one item balances of individuals and otherwise not classified amounts; *cf.* Lauchlin Currie, "The Economic Distribution of Demand Deposits," address before the American Statistical Association, December 28, 1937.

³ Here the question arises as to how effective will be the stricter formulation of Section 102 of the Revenue Act of 1938.

Tax-exempt securities, however, as long as they are available, probably provide a safer and easier means for the taxpayers of the high brackets to minimize their tax bill.¹ Persons who are tax-conscious in their investment attitude will see the advantage in tax-exempt securities as well as the advantage of transferring revenue into capital gains. It may even be that rising stock quotations will induce stockholders of the higher brackets and managers of personal holding companies to sell further parts of their property and to convert them into tax-exempt securities. This tendency may be strengthened by the revision of the capital gains tax, which makes it easier for stockholders to sell securities held for more than two years.

The most important change that can be expected in the attitude of the investor is that he will be more inclined to realize a gain on an asset held more than eighteen months. This change may become effective only after a new rise in prices has occurred, though the investor's knowledge that he will be free to realize without a heavy tax after eighteen months or two years may have a certain effect immediately. Such an immediate effect, however, may well be attenuated by uncertainty as to whether or not the same favorable tax provisions will still be in effect after two years.

Thus it seems questionable whether this group of "potential" investors for appreciation will be induced by the tax revision to buy stocks as long as tax-exempt securities are available. Some investors may be again inclined to embark on speculative purchases; others may be inclined to sell stocks, as soon as their prices are higher, in order to buy tax-exempt securities. It is impossible to say which of these tendencies will be stronger. But if the tax privilege for government and municipal bonds should

¹ At the end of April 1938 the yield of municipal bonds was 2.93 per cent (Standard Statistics), of common stock 5.10 per cent (Moody). Thus the yield of the tax-exempt securities was 42 per cent lower than the yield of common stock. But for investors in the income brackets above \$60,000 the net yield of stocks (after payment of the income tax) was lower. Considering the difference in risk and liquidity the tax-exempt securities appear to be preferable investments even for the middle brackets of taxable incomes.

be canceled, at least for future issues, then the revision of the capital gains provisions may influence investors of this type to a significant degree.¹

PROBABLE INFLUENCE ON RECOVERY

If it should happen that an increased willingness of wealthy persons to invest their current savings or liquid funds in stocks will not be offset by the tendency of other wealthy persons to sell stocks and invest in tax-exempt securities, what effect would this strengthened demand for stocks have on business conditions in general? It might mean that business would be able to float new issues on better terms,² but here is the point where it is necessary to distinguish between the alternative assumptions which were mentioned at the beginning. Under the assumption that there are no other recovery factors than the tax revision, better terms for capital will be effective only if business has a demand for capital which cannot be met at present on tolerable terms. In a depression such a capital demand is unlikely to exist.³ In a declining market not many businessmen are willing to expand, even if the terms of financing are favorable. They may wish to float new securities, but only for refunding other liabilities.

Could a rising stock market cause recovery in an indirect way? The stock exchange is, rightly or wrongly, regarded as a business barometer by many businessmen. Rising quotations may strengthen their confidence in future business conditions and induce them

¹ This article will not attempt to discuss the legal possibilities of canceling the tax exemption for government and municipal securities, or the question of how effective such cancelation would be if it applied only to further issues of such bonds and not to issues already outstanding.

² For the relationship between stock market conditions and new issues cf. J. A. Ross, *Speculation, Stock Prices and Industrial Fluctuations* (New York 1938) pp. 350 ff., and J. B. Williams, *The Theory of Investment Value* (Cambridge, Mass., 1938) pp. 256 ff. Only in 1936-37 was an increase in stock prices not accompanied by a corresponding increase in the floating of new issues.

³ Some concerns, however, might have a demand for capital even in a depression. If such a demand is not satisfied it may be due to a lack of confidence in the profitability of the investment rather than to a lack of capital supply; cf. footnote 2, page 270.

to replenish their stocks. This could lead to an actual improvement in business conditions and encourage others in turn to expand and make use of the increased capital supply. Such a development is certainly not impossible, but it seems rather improbable. The foregoing analysis of the tax revision's probable influence on the attitude of the investor makes it appear not very likely that the tax revision alone can result in a substantial increase of stock prices. Such an increase can be expected only if there are other factors visible which make it possible to expect improved business conditions and earnings. A slight increase in prices will hardly induce businessmen to increase inventories and expand equipment unless they have already had increased orders from customers.¹ If this conclusion is tenable the tax revision will not in itself suffice to bring about recovery.

The situation will be different, however, under the second assumption, that is, that other factors will initiate recovery and the tax revision will merely substantiate it. If a revival in building activities or in government investment should lift again the level of consumption and investment, then replacements and later on new purchases of equipment will follow.² It must be assumed that in the first phase of a new recovery development replacements and expansion will be financed by current depreciation allowances and undistributed profits. At least the larger corporations are as liquid in 1938 as they were in 1934, and they will probably be able again to replenish inventories by using cash and increasing their current liabilities. But every new recovery must lead sooner or later to a demand for new capital; just as in 1936-37 there appeared a need for long-term or equity financing, so must such a need appear again with a new upswing. This holds true especially for certain branches of industry which depend on new capital for expansion because of their technical structure (rail-

¹ This argument leads to the very moot question as to whether confidence is a factor which can, genuinely and independently of other factors, cause business fluctuations of more than temporary duration.

² This presupposes that there are opportunities for investment which will become effective if market conditions are favorable; cf. Colm-Lehmann, pp. 24 ff.

ways, utilities, housing); it also holds true for smaller or middle size businesses which can finance only a limited degree of expansion by their own means.¹

Thus, in short, the duration of a future recovery will depend on the opportunities for expansion on the one hand, on the capital supply for financing on the other.² A great deal of this future financing will be done by institutional capital (especially life insurance) and by self-financing of corporations, but certain types of business which are not eligible for institutional investments must depend on the possibility of floating new issues on favorable conditions.

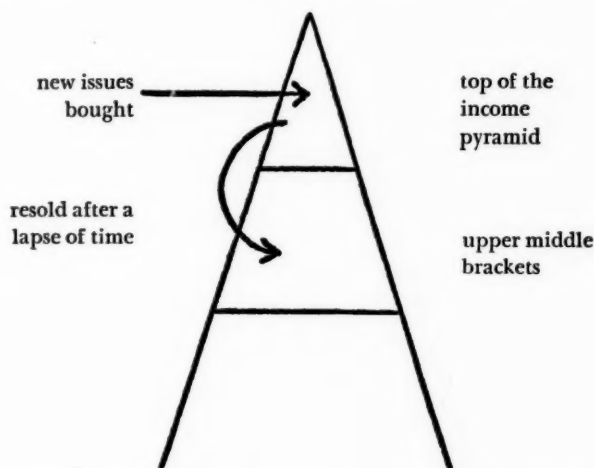
How far will the possibility of financing corporations of the latter type be influenced by the revision in the capital gains tax? It was pointed out above that the tax revision can be of major

¹ For the financing of the last recovery period cf. Alexander Sachs, "Summary of a Comprehensive Financial Analysis of the Causes of the Slump" in the *Annalist* (January 14, 1938) pp. 35-36. That his sample of sixteen companies for 1936-37 exaggerates the relative importance of financing by short-term liabilities is shown by the Standard Statistics analysis in its Survey of June 3, 1938 (Special Supplement, "Standard Trade and Securities," cited hereafter as Standard Statistics 1938), which uses a larger sample. It should be kept in mind that in 1937 inventories were probably higher than was required by the level of production, so that a future recovery will not necessarily lead to the same accumulation of inventories. The net working capital of leading industrial corporations (Standard Statistics' sample) was 8.2 billion dollars at the end of 1937, 7.6 billion dollars at the end of 1934.

² It is not possible here to enter again into a discussion of whether the early interruption of the last recovery period was due to a lack of capital of the right quality (cf. Colm-Lehmann, pp. 57 ff.). The Investment Bankers Conference has summarized the findings of a survey (*Has New Capital Been Available for Expansion of Sound Manufacturing Enterprises?*, Washington, April 1938) in the declaration that "In the combined judgment of American industry there is not now and there has not been during the past two years any substantial lack of new capital available for expansion of sound companies" (p. 3). This summary could be made only after a part of the questionnaire answers had been eliminated. The question asking the recipient whether he believed that in his section there had been a lack of new capital available for expansion of sound companies during the past two years (1936-37), was answered by 546 firms, of which 24 per cent said "yes." This does not seem to be negligible. Of 672 firms, 124 reported that they had sought new capital in the past two years; 184 volunteered information on whether they need capital at the present time (1938), and of this number only 8 declared affirmatively.

importance only for those wealthy individuals who may be willing to invest for appreciation. For the sale of new issues which are not eligible for institutional investment the dealers and investment bankers depend on wealthy individuals of this type. The costs of distribution become too high when bankers try to sell new securities to investors of smaller means who prefer to buy seasoned securities. Only in the years of the speculative fever of the "New Era" were new issues being sold to a broader public, and this was certainly an exception to the usual procedure.

Yet the stock exchange and the broad mass of speculators are of indirect importance for new business financing. The process of new financing can be illustrated in the following schematic way:



New issues are sold predominantly to the more wealthy individuals who are best able to bear a risk, but when the securities are "seasoned" these investors can sell them to the broader public through the stock market. The wealthy investors are then able again to buy new issues. When the process works in this way at least a part of the property of the wealthy is used as a kind of "revolving fund" for financing new issues. Only then is the supply of venturesome capital not confined to the relatively unimportant current savings of those individuals who are in a position to bear risks.

It is probable that formerly at least some new financing was done in this way. At the present time the wealthy classes do not fulfil this function of risk bearing. There are many reasons why they now tend to be led by a preference for liquidity and security. The previous capital gains tax probably strengthened this tendency, for its "aging" provision delayed the steady realignment of stock ownership.

If under the new provisions wealthy investors will indeed be ready to part from their holdings after a shorter time, it may be that a future recovery will not lift security prices as high as the last recovery did.

In short, it seems quite certain that the revision of the tax will give wealthy investors a greater inducement to realize gains and losses than did the former law. It is more doubtful whether the revision of the capital gains tax alone will induce these individuals to reinvest in stocks as long as tax-exempt securities are offered as an alternative investment. Only a revision of tax exemption in conjunction with the revised capital gains tax could indicate whether the refusal of wealth to take risks has really resulted from tax measures or has been mainly due to other factors. If the latter should be the case it could be attempted to develop institutions (such as investment trusts) which would supply "venture-some" capital but by carefully spreading the risk would diminish the hazard of the investors.¹

In a developing economy "risk bearing" is an essential factor. If this factor is not provided by individuals it must be provided by other agencies. Large corporations have already become the most important promoters of new ventures in many fields. Also the government is playing an increasing role as risk bearer. A development by which the function of risk bearing would be definitely shifted from wealthy individuals to corporations and to the government would have important implications. It remains to be seen whether a tax revision will be able to reverse this trend.

¹ Cf. Fritz Lehmann, "The Problem of Financing Small and Intermediate Industries" in *Social Research*, vol. 2 (August 1935) pp. 287-309

Corporate Profits

PRINCIPLES OF TAXATION

The undistributed profits tax has probably been the most criticized piece of legislation during recent years. In the Revenue Act of 1936 a normal corporate profits tax was provided with a slight progression from 8 per cent to a maximum of 15 per cent. On top of this was levied a tax ranging from 7 per cent to 27 per cent of the undistributed profits. This tax was graduated according to the ratio of profits retained from distribution.

The revised law differs from the older one in five main respects which should be briefly mentioned.

First, the Revenue Act of 1938 increases the normal profits tax to a flat rate of 19 per cent, retaining the regression for corporations with small profits.

Second, it provides for a credit of $2\frac{1}{2}$ per cent of dividends which are distributed,¹ but this applies only to corporations with

TABLE II

PERCENTAGES OF CORPORATION NET INCOME TO BE PAID AS INCOME TAX,
ACCORDING TO REVENUE ACTS OF 1936 AND 1938*

Percentage of Net Income Paid in Dividends	Net Income Before Tax Payment							
	\$10,000		\$100,000		\$1,000,000		\$10,000,000	
	1936	1938	1936	1938	1936	1938	1936	1938
100	10.40	13.25	13.84	16.50	14.88	16.50	14.99	16.50
90	10.40	13.25	13.84	16.75	14.88	16.75	14.99	16.75
80	11.07	13.25	14.27	17.00	15.24	17.00	15.34	17.00
70	11.77	13.25	15.35	17.25	16.27	17.25	16.36	17.25
60	12.47	13.25	16.99	17.50	17.88	17.50	17.97	17.50
50	13.17	13.25	18.78	17.75	19.63	17.75	19.72	17.75
40	13.87	13.25	20.98	18.00	21.83	18.00	21.92	18.00
30	15.08	13.25	23.40	18.25	24.23	18.25	24.32	18.25
20	16.78	13.25	26.10	18.50	26.93	18.50	27.02	18.50
10	18.62	13.25	28.80	18.75	29.63	18.75	29.72	18.75
none	20.82	13.25	31.50	19.00	32.33	19.00	32.42	19.00

* It is assumed that no part of the income is derived from tax-exempt securities or from stock of domestic corporations.

¹ Or which the stockholder consents to have taxed as his personal income even if the amounts are not actually distributed.

a net profit above \$25,000. Table II illustrates how the Revenue Acts of 1936 and 1938 affect corporations of various brackets according to different ratios of distribution. The tax remains approximately the same for smaller corporations distributing about 50 per cent, and for larger corporations distributing 60 per cent, of their taxable net income. Corporations paying out less than these percentages are taxed at lower rates than under the previous law; those distributing more are taxed at higher rates.

Third, although the discrimination between distributed and undistributed profits is of little practical importance at the present rate, the new act refines the principle of this tax in several directions. One refinement is the permission to regard as dividends amounts which are used for, or set aside to pay, certain types of indebtedness. By this provision it is intended to exclude cases in which a corporation is taxed on undistributed funds which it is legally bound to use for debt retirement.¹

Fourth, a refinement of great importance (because it refers to the profits tax as a whole and not only to the credit for dividends paid) is the permission to taxpayers in a few industries to follow a different method of taking inventories. An increase in the price of raw materials within the taxable year leads to an increase in profits under the traditional rules of taking inventories. This profit is real but it may be unrealized. Declining markets will have the opposite result. In a tax system that allows for only a limited carryover of losses this method results in higher average taxes for businesses with highly fluctuating prices of raw materials. The "last in, first out" principle of determining the cost value of inventories—which is now applicable in a few branches of industry—eliminates from the income statement profits or losses on unsold stock. This refinement may become of greater importance if a larger credit for dividends paid or a new undistributed profits tax should be enacted in the future. It certainly

¹ Cf., for example, Ellsworth C. Alvord, "The Taxation of Undistributed Profits from the Business Point of View" in Tax Policy League, *How Shall Business be Taxed?* (New York 1937) pp. 98 ff. A similar provision in the law of 1936 was narrower and did not cover all cases.

cannot be the intention of the law to induce corporations to distribute unrealized profits which derive from temporary fluctuations in the value of inventories. This inducement has now been eliminated in a few branches of industry.

Fifth and finally, the provisions for a "surtax on corporations improperly accumulating surplus" have been strengthened. It is now up to the corporation to prove that its accumulation of profits is required by "reasonable needs of the business."

The Revenue Act of 1938 virtually abolishes the undistributed profits tax, but it maintains the principle. Since this analysis is devoted mainly to the tax revision's possible effect on recovery the "principle" of the undistributed profits tax can be only summarized. Four main arguments have been proposed for it.

First, it is held that a tax system which contains a steeply progressive individual income tax, and a less progressive or flat rate corporation tax, puts a premium on withholding profits from distribution. This premium ought to be diminished by a special tax on the undistributed portion of profits (or by a tax credit for the distributed portion). For stockholders in the high brackets the undistributed profits tax of 1936, however, eliminated only a small part of the tax advantage of retainment.¹ It remains to be seen how effective will be the present rigid reformulation of the penalty tax for improper accumulation (Section 102).²

Second, economists who believe that the American economy is unbalanced because of oversaving and underconsumption regard an inducement to a high profit distribution as a means of stimulating the stockholders' consumption and of curbing reinvestment of profits. But if there is indeed a tendency for savings to outrun investment opportunities it is probable that the oversaving takes the form of institutional capital supply; in this case there may still

¹ Cf. Colm-Lehmann, p. 36, and also H. L. Lutz, "The Principle of the Undistributed Profits Tax" in National Tax Association, *Bulletin* (April 1938) especially p. 203.

² Cf. Maurice Wertheim, "The Undistributed Profits Tax" in *Harpers Magazine* (February 1938), and the same in Senate Hearings, pp. 381 ff.

be a scarcity in the supply of equity capital. Under these conditions it would be a mistake, with the situation in the capital market what it is, to curtail business capital as a means of curtailing capital formation.

Third, some economists hold that the method of self-financing leads to a waste of capital and to a strengthening of monopolistic tendencies. They believe that the instrumentalities of the capital market provide the most economic distribution of available capital to those places in the economy where it is most needed, and provide new enterprises a better chance to develop. This argument presupposes a perfectly functioning capital market. In recent years only a small fraction of distributed profits has found its way back into new issues of business corporations. Stockholders have been deterred from reinvesting dividends in business not only by personal taxes and consumption expenditures but also by the capital gains tax and the inducement to invest in tax-exempt securities. As demonstrated above, it is not likely that the change in the capital gains provision alone, without some change in the matter of tax-exempt securities, can restore a well functioning private market for new issues. As long as this market does not provide sufficient capital of the right quality the method of self-financing may be regarded as a useful outlet for meeting the demand for business capital, especially in regard to corporations which do not belong among the favorites on the stock market.

Fourth, it is held that self-financing as a method of procuring capital evades such public and governmental supervision as is exercised through devices like the Securities and Exchange Commission. Some economists believe that from this regulation of the security market there may develop a regulation of investments in general as a measure of cyclical policy. If this should happen it might be necessary to enlarge the portion of the capital flow which passes through the supervised channels and to tax the portion which escapes the supervision. It can hardly be said that the degree of supervision has yet reached a mark where this argument becomes effective.

These arguments in favor of a tax discrimination between the distributed and undistributed portions of profits cannot be dismissed as unreasonable. On the contrary, there may develop conditions under which such a tax principle would assume great importance. Under present conditions, however, when a well functioning market for new capital issues has not yet been restored and when it is necessary to support business expansion wherever an opportunity exists, such a tax must be regarded as harmful to recovery. Therefore the present virtual abolition of the tax, though maintaining and refining the principle for some future need, appears to be a wise solution for the time being.

In the case of the capital gains tax, as has been said, the effect of the revision may be impaired by the fact that since the very time of its enactment doubts have been raised about its permanence. These doubts may impair its influence on prospective investors who wish to be sure when they buy stock today that they will not have to pay an excessive tax if they desire to sell two years hence. Uncertainty about the future profits tax, however, will have no such injurious effects. A corporation drafting a plan for expansion today faces a much greater uncertainty with regard to future profits than with regard to future profits taxes. Businessmen must know that in financing their projects they can rely either on self-financing or on the capital market. The misfortune of the undistributed profits tax of 1936 was that it was enacted at a time when the market for new issues was not functioning satisfactorily.

PROBABLE INFLUENCE ON RECOVERY

No accurate estimate is possible as to how much the enactment of the undistributed profits tax influenced the disbursements of dividends in 1936 and 1937, and how much the virtual abolition of this tax may influence the retention of profits in 1938.

The undistributed profits of corporations reporting a net income were 42.8 per cent of net profits in 1928, 40.0 per cent in 1929, 24.4 per cent in 1933, 20.0 per cent in 1934, 18.9 per cent

in 1936.¹ Comparison between the rates of retention before and after the enactment of the undistributed profits tax does not show the influence of the tax; business conditions were very different in 1934 and 1936,² and the years of the last prosperity period are not entirely comparable, because of changes in the statistics. Nevertheless, as the rate of retention usually increases with increasing profits a substantial increase in the ratio was to have been expected from 1934 to 1936. That this did not materialize must be attributed to the influence of the tax.

Comparable statistics are available for a sample of corporations. Business conditions in 1937 corresponded fairly closely to conditions in the average of the years 1927 and 1928.³ At that time the industrial corporations included in this sample retained 35.8 per cent of their net income; they retained 26.0 per cent in 1936, and 28.3 per cent in 1937. Thus in the latter year the rate of retention was 21 per cent lower than in 1927-28. The influence of the tax was probably greater on the corporations not included in this sample, that is, on the railways, public utilities⁴ and smaller industrial corporations. Therefore it seems reasonable to assume that the undistributed profits tax induced corporations in favorable years to retain 25 to 30 per cent less than they would have retained without the tax.

¹ Figures for 1928-34 on the basis of Statistics of Income; for 1936 from House Hearings, pp. 14 ff. The figures for 1936 contain only a part of the corporations included in the complete Statistics of Income (about 27 per cent of the number, 37 per cent of the total capital). The ratio of retention for 1934 was lower than might have been expected, because consolidated returns have been disallowed since that year.

² The Standard Statistics index of corporate earnings (1928-30=100) was 36.1 in 1934, 76.5 in 1936.

³ The "leading American industrial corporations," according to Standard Statistics 1938, and Standard Statistics, "Standard Trade and Securities," August 13, 1937 (cited hereafter as Standard Statistics 1937) earned 9.7 per cent on invested capital in the average of the years 1927 and 1928; 9.2 per cent in 1936, and 9.8 per cent in 1937.

⁴ For railways and public utilities the statistics for 1936 are the latest available at the present time. They show a large reduction in the rate of retention, but this is partly due to the fact that for these corporations the comparison of 1936 with 1927-28 is not as adequate as for the industrial corporations.

On the basis of profits in the years 1926 through 1928 this corresponds to between 700 and 850 million dollars; on the basis of profits in the years 1936 and 1937¹ it amounts to about 600 to 720 million. For the year 1938 the rate of retention will be low with or without an influence of the tax. It may be estimated that earnings in 1938 will be back to the level where they were in 1934. In that year corporations reporting a net income retained about 1 billion dollars from distribution. The same corporations—in a year of similar business conditions — might have distributed about 200 million of this amount to avoid the payment of an undistributed profits tax. Thus it seems to be a reasonable guess that the undistributed profits tax might have induced corporations to distribute in prosperous years 600 to 800 million dollars, in depression years about 200 million dollars, more than they would have distributed without such a tax.² It can be expected that the virtual abolition of the tax may have the opposite effect, that is, that the corresponding amounts will be added to the surplus.

There is of course still the credit of 2½ per cent on dividends paid, and there is section 102 concerning "corporations improperly accumulating surplus." Nevertheless business today is more conscious than before of the importance of undistributed profits for financing expansion, because the propaganda against the undistributed profits tax explained to everyone the advantages of "plowing profits back." Therefore it can be expected that the rate of retention will increase in coming years.

Retention of profits in a period of prosperity and retention in a period of depression are different not only with regard to the quantities involved. In a depression it is likely that the amounts retained will be used mostly for debt retirement, while if these amounts had been distributed to the stockholders a significant portion would probably have been used for expenditures. Therefore abolition of the undistributed profits tax in a period of de-

¹ Derived from Standard Statistics' index of corporate earnings.

² The tax's influence on the distribution of "deficit dividends" is here neglected; cf. Colm-Lehmann, pp. 34 ff.

pression has immediately a depressive influence which increases the need for reflationary measures like government investment.

In a period of recovery larger corporations depend less on undistributed profits for expansion than do the smaller corporations. It is worth noting that the leading industrial corporations (Standard Statistics' sample) increased their property accounts in 1937 more than they did in 1928, even though in the earlier year they floated much larger issues on the stock market and retained a higher ratio of their profits. In 1928 they increased their investments in other

TABLE III
BALANCE SHEETS OF LEADING INDUSTRIAL CORPORATIONS, 1928 AND 1937^a

Requirements for Funds

	1928	1937
Increase in property accounts	583	683
Increase in investments	200	128
Increase in cash	641	-287
Increase in receivables	254	36
Increase in inventories	188	826
	<hr/>	<hr/>
Increase in total assets ^b	1805	1362

Sources of Funds

Increase in funded debt	21	114
Increase in preferred stock	5	71
Increase in common stock ^c	752	246
Increase in surplus	722	554
Increase in current liabilities	254	284
	<hr/>	<hr/>
Increase in total liabilities ^b	1805	1362
Net income	2614	2339
Undistributed profits	1079	664

^a Standard Statistics 1937 and 1938. Figures for 1928 are from 399 industrial corporations, for 1937 from 385.

^b Includes also other plus or minus items not listed.

^c Includes premiums from the sale of capital stock.

corporations and enormously strengthened their cash holdings. In 1937 they financed, largely from their own cash, a large accumulation of inventories.¹ If they had retained more profits they would probably have maintained their cash but not invested more in plant and equipment. It is possible that corporations whose financial conditions are as favorable as those of most of these leading industrial corporations can once more finance a certain period of recovery by their own means. But sooner or later they must either issue more securities or retain a higher percentage of profits for financing further expansion.²

The situation is different, however, in the case of non-industrial and smaller industrial corporations. Smaller corporations will probably reach earlier the point where they need a relatively high amount of undistributed profits for further expansion. No statistics are available at the present time to indicate how smaller firms financed expansion in 1936 and 1937, but observers concur in the opinion that undistributed profits have a vital importance in the expansion of smaller and middle size firms, especially at a time when the market for new issues does not function satisfactorily.

Thus the revision of the profits tax too, while not a stimulus to recovery and possibly not a lasting improvement in the tax system, may help to transform a coming recovery into a longer lasting prosperity, if it is true that such a prosperity depends on investments in many fields.

Conclusion

The tax revision in itself is no recovery measure. It can be effective only if recovery is initiated by other factors. If such other factors restore consumption and production, and thereby the confidence of the business community that further expansion of plant

¹ At the end of 1937 cash was 24 per cent below cash at the end of 1928, inventories 16 per cent higher (Standard Statistics 1937 and 1938).

² It must be emphasized again that a conclusion for future recovery years that is based on experiences in 1937 is made difficult by the extraordinary accumulation of inventories in that year.

and equipment will again promise profits, then the tax revision may help to provide capital, especially for businesses whose securities are not eligible for institutional investments. Yet it is doubtful how effective the tax revision will be in this respect as long as tax-exempt securities still attract the taxpayers of the high income brackets.

Lasting recovery cannot be achieved by a single measure. It is not possible in one period to expect everything from government spending, without due attention to the restoration of business investments, and in another period to expect everything from removing barriers to the capital flow when, because of market conditions, business has no use for capital. Lasting recovery can be achieved only by a comprehensive program in which government investment and tax revision have their proper place in combination with quite a number of other equally necessary measures.

Moreover, recovery measures in our time must fit into a program of reconstruction in which they are combined with measures of reform. Reform measures should never be merely destructive, preventing something. If they are not also constructive they will have a depressive result. A reform measure which, for example, curbs the speculation of the wealthy or the accumulation of profits by corporations, must make sure whether such activities do not fulfil a productive function, and, if they do, it must at the same time develop other agencies to take care of these functions. Every reform policy must compromise between the desire to realize goals in the shortest possible time and the need to prevent disturbances in economic development. For such disturbances may nullify even the most desirable reform. In any enduring economic reform the achievement of steady production and employment is at once a goal and a prerequisite.

BALANCE OR PREDOMINANCE IN EUROPE?

BY HANS SIMONS

IN GOING to Europe one may cross the ocean on a choppy sea while the ship is rolling quite independently on a ground swell which dominates the rhythm of all life on board. The same experience is met on the continent. Of course there are everywhere the white-capped waves of national enthusiasm. One sees the apparently calm sea of normal life or breathes the air-conditioned atmosphere of conferences. Yet the ground swell is also unmistakable. This time, however, it seems to be the forerunner of a storm, whereas on the ocean it was supposed to be the remnant of bad weather. It is hard to describe this movement adequately, for it is intangible despite its all-pervading strength. Certainly it is not fear. On the contrary, one finds a brave acceptance of something unavoidable, a stubborn readiness to keep on, regardless of the future. Yet as to this future there is a general fatalism; even those who hope for a solution of pressing problems do not expect the solution to be lasting, and those who enjoy success today frankly admit that they foresee failure tomorrow. Whether justified or not, this fatalism constitutes a major element in European politics today. Officials still pretend to be optimistic, but the public is pessimistic nonetheless.

I

A large part of all political discussions and speculations, in Europe as elsewhere, is conditioned by past events. The storm which raged over Austria from the 11th to the 13th of March this year, not yet fully subdued, and the clouds that have been gathering over Czechoslovakia since the 20th of May, not yet dispersed, have made a tremendous impression. They are taken as the main elements of

all political weather forecasts, in popular talk as well as in expert analysis. People see their double significance as driving forces and as harbingers of definite developments in European politics. From these viewpoints both shall be discussed further.

For the average German the annexation of Austria was something entirely natural as far as traditional ambitions and present expectations are concerned. Only the speed with which things developed during the final days and the thoroughness of the assimilation were surprising. Friedrich List had already envisaged a political and commercial union of central Europe which was to include Belgium, the Netherlands and Switzerland with a united Germany. Austrians, Germans and Magyars should extend an economic empire to the Aegean and Black seas. In this plan German unity based on economic strength was to be the nucleus of a European organization which in its turn should help to make possible the peaceful cooperation of the whole world. Similar ideas played their part in 1848, when the national assembly tried to establish a Greater Germany but failed because Austria, with her vast non-German parts, could not be brought into line; nor could the German parts be broken off from inclusion in Germany. The concept of German-Austrian union derives from that period. Finally, even the smaller task of the German National movement remained unsolved, as most of the German princes, above all King Friedrich Wilhelm IV of Prussia, would not cooperate with a democratic and revolutionary movement. Nevertheless there remained an interest in a central European economic cooperation, even in Austria. Politically the failure of 1848-49 was decisive. Bismarck united Germany without Austria. His work, however, was regarded as incomplete. Arndt's song, though written for another period, still remained popular and was taught in all German schools: "His [the German's] fatherland must be greater."

Although Austria was politically separated from Germany, plans for economic union persisted and seemed the more realizable as the alliance of 1879 restored political cooperation. Bismarck's successor, Caprivi, intended to unite by trade agreements not only

Germany and Austria but Switzerland, Italy, Serbia and Roumania as well. At the beginning of the century private interests also organized an economic league for central Europe, but this failed to gain any strong influence. Public opinion at that time was much more interested in colonial policy and in economic expansion on a world scale. Africa, the Near and the Far East, had a firmer grip on national imagination than the old dream of Greater Germany.

The latter, however, was revived by the World War. The armies of the Central Powers occupied a territory which embodied a new central Europe. Friedrich Naumann rationalized and at the same time popularized the result of circumstances and of military actions into a new national program for victorious Germany. Even more than his book the semi-official travel agency "Mitropa," which was established during the war and is still in operation, made the phrase and the concept of "Mittel Europa" generally known. Private groups of Austrians and Germans, the so-called Leagues of Brothers in Arms, tried to develop the German-Austrian alliance into a kind of federation. Though they enjoyed official support nothing definite was achieved.

It is fair to say that generally a German-Austrian union has been regarded as the beginning of a central European development of greater range. That was true while Austria was still the Austrian-Hungarian Empire, but a similar concept still prevails. The incorporation of Austria, then, is the fulfilment of wishes which since the last war were cherished by a majority of people in both countries. At the same time it is a partial realization of much older plans and hopes which that war only strengthened and which defeat did not destroy. Finally it is looked upon as the first instalment of what most Germans seem to expect from fate, that is, gradual reparation for an undeserved misfortune. Hence it is not only an end in itself but also the start toward a further goal. These are the three sources from which arose the enormous wave of enthusiasm that swept Germany after the Austrian government surrendered.

With the historical trend there coincides a new political tech-

nique which is likely to be successful, though only with the smaller nations which make up most of central and eastern Europe. Today German officials protest strongly against the use of the word "conquest" for what happened to Austria. It does not matter whether this traditional term is used, because the facts themselves, and even more the forms under which they were established, represent a new kind of annexation. It is conquest from within combined with that from outside—"peaceful penetration" coupled with powerful pressure which makes the show of force comparatively more important than its ultimate use. The Viennese opponents of National Socialism who for hours saw heavy German bombers circle over their heads, or sympathizers of Schuschnigg who heard the familiar noise of military units moving through cities and villages, certainly were not encouraged to lodge any protest against what took place. The situation of any dissenting group faced by a modern military machine is vividly expressed in the words of one of the unwilling: "We had to take part in the demonstrations but not in their enthusiasms." It is the sad story of all people, whether in Spain or China today, in Ethiopia yesterday, or elsewhere tomorrow. They hail the victor mainly because the legitimate ruler during a critical period had to use methods quite similar to those of conquest, merely in order to keep in power. People become exhausted, and an ever increasing number come to act exactly as they feel: "What is the difference?"

Pressure comes not only from within. The Austrian instance shows also the characteristic feature of a new form of war wherein the triumphant entry of the conqueror is the end not of military fighting but of an elaborate process by which the enemy is wearied. Insidious cooperation alternating with what could be called international picketing of the other country, malicious propaganda temporarily interrupted by pious peace proposals, all sorts of intimidations directed against the government and combined with lavish support given to the rebellious elements—all these methods are too well known to need any further description. Their main importance is that they not only precede but replace warfare. If

they are successful in the end, they are acclaimed also by those who would object to actual war and would grow critical, disappointed and finally oppositional under the strain of martial sacrifices. The procedure which proves to be effective as a new form of conquest, without including any risks at home, is not likely to be abandoned. On the contrary, it is already working in different parts of the world, and its prospects are the better since internationally too it has not yet met efficient resistance.

It is on international reaction, however, that the choice of the object depends. Totalitarian governments are fixed in their methods, but adaptable regarding their aims, while democracies may change their techniques much more easily but find it difficult to shift their objects. German and Italian political moves are often misinterpreted because this consistency in technique is confounded with singleness of purpose. It is the general European situation more than a preconceived and fixed policy that indicates the dictatorships' future course. Underlying the moves of governments admiration and respect for totalitarian efficiency increase. Impressed by success, public opinion in Europe sees in the end of Austria the writing on the wall for the whole European political structure. The pace at which the German republic recovered the position of a great power, succeeding in easing the burden imposed on it by the Treaty of Versailles, and the pace at which it adapted its economy to changed conditions, have been entirely forgotten. The worldwide depression interrupted that development nationally as well as internationally. Furthermore, a National Socialist Germany has been far more successful in a much shorter time. Today therefore the thesis is generally accepted that National Socialism is the result of the peace conditions and the only means of changing them, though this is only a superficial explanation of an additional circumstance that helped National Socialism into power. Lack of perspective, on the one hand, and exaggeration on the other, both usual features of public response to any event, have created that awe and fear which Germany today commands. This, and the enormously increased German self-reliance, are per-

haps the most important results of the Austrian affair in view of future developments.

Peaceful preparation of an Austrian-German union along federal lines did not work. The customs union which both countries planned in 1931 was opposed by France and the Little Entente as well as by the political and legal machinery of the League of Nations. Yet when Austria was completely swallowed and military might for the first time challenged the territorial status quo of postwar Europe, neither the League nor any single power or group of powers took action. Such plain facts, however they may be modified when related to accompanying events and conditioning circumstances, impress the average citizen in all countries more than any official declarations. Most people now take it for granted that Germany after all won the peace. They may dislike the methods by which she has done so but they resign themselves to the fact that only these methods were successful.

Most people regard success as the highest form of justification. For them, strength of armament and strength of argument become almost identical. Therefore the general claims of Germany are accepted without dispute, though there is resistance against this or that particular demand. For Germany then it is most important to find the line of least resistance. As long as there is any choice among the objects of an aggressive policy, it would be wiser to follow that line than needlessly to antagonize organized forces of defense. Another historical result of the German coup in Austria may be that the German leaders have discovered how definite is that line and how weak that resistance. It seems unlikely that power relations in Europe will soon change to an extent which will open an easier road of expansion to Germany than the one she is treading today.

Thus to a rather inflexible technique there is added, at least for the time being, a well determined object. Expansion in central and eastern Europe fits of course into the program of National Socialism. But its chances of success are partly created by the general submission to some of the concepts and most of the results of

German foreign policy. Germany had a perfect case for being dissatisfied, so the argument runs. Peaceful protests against the unjust conditions of Versailles did not succeed. So, in order to press her case, she rightly developed her military strength. By rearming she became again a great power. As a great power she is entitled to her share of the wealth of the world. Obviously the stronger she grows the more she may ask. So the vicious round of reasoning takes its spiral course into ever more claims and ever new justifications for them. General intellectual or moral unwillingness to put a stop to the indulging of expansionist policies forces an opening in the last wall of international order, and a much more formidable one than that made by German propaganda, which only uses the entry already prepared for it.

There is still another mental attitude which tends to lure National Socialism into this policy. Germany is the only great European power which, on the basis of the nation-state and of the community of blood, may claim large ethnical groups still belonging to other countries. The taking of Austria was justified especially on this ground. To endorse the thesis of one nation united in one state on one territory, and to stress the idea of national loyalty on racial grounds, is to invite the policy of aggrandizement which Germany has embarked upon. It is surprising to find how many representatives of public opinion in Europe are actually doing this. One could say that they are providing the suction which complements the German pressure. Once the rising of water into a "vacuum," as produced by a pump, was attributed to "horror vacui," which was supposed to be an elementary force. Today one is tempted to ascribe to a similar force those political moves which become successful mainly because they are not opposed by consistent concepts or by the intellectual and moral courage by which such concepts are maintained. Austria presented such a vacuum. The way that German interference there was tolerated and its success accepted certainly indicates the important part which general submission played in the event.

Whatever were the special motives of the several powers insist-

ing on Austrian independence, their efforts were neither entirely selfish nor exclusively anti-German, as is so often assumed. As late as 1935 the then British Foreign Secretary, Sir Samuel Hoare, declared: "Time after time we have explained our considered view that Austria occupies strategically and economically a key position in Europe and that a change in her status would shake the foundations of European peace." His words express the policy underlying all the early actions of Great Britain, France, Italy and Czechoslovakia, in which other nations joined, to maintain Austrian independence. On October 4, 1922, they undertook to assist Austria in her economic and financial reconstruction. On July 15, 1932, Great Britain, France, Italy and Belgium agreed to a similar undertaking. In both cases support was given in exchange for Austria's solemn pledge to maintain her independence, and as a means of enabling her to keep that promise. The crucial importance of Austria's position was stressed again in the joint British, French and Italian declaration of February 17, 1934, which was repeated on September 27 of the same year, and further in the French-Italian Protocol of January 7, 1935, which was complemented by a British-French declaration of February 3 of the same year. Finally, the famous resolution passed by Great Britain, France and Italy in Stresa on April 14, 1935, corroborated the earlier statements. They all were based on the peace conditions of 1919 which in Article 88 of the Treaty of Saint-Germain and in Article 80 of the Treaty of Versailles accorded a special role to the Council of the League of Nations in connection with the status of Austria.

The Little Entente also was vitally interested in Austrian independence, as without it Danubian cooperation on equal terms would have been impossible. Yet in spite of all these interests the corner stone of central European reconstruction, which was under a literally tenfold international guarantee, was seized by Germany. The League kept silent. Some of the guarantors objected mildly. Italy agreed. Austria had been protected for the sake of European peace. But also for the sake of peace she was abandoned.

When her own resistance was sufficiently weakened to make peaceful surrender possible, she was left alone. The breakdown of collective guarantee was complete.

But why, if Germany is following the line of least resistance, does she at the same time antagonize even her friends by the measures taken against the Jews, against political opponents and against certain vested interests of the upper class? Why does she disappoint the cherished expectations of so many people who hoped for a mitigation at least of the methods if not of the program of National Socialism? As far as one can judge, the policy now practiced in Austria is not primarily impelled by radical forces of the Austrian party; the latter seems rather to disapprove of some of it. Much more it is a social change planned according to the experience of Germany; there such a policy has after all had the endorsement and even the support of a large part of the lower middle class and of the workers. The domestic strength of National Socialism, much as it is enhanced by its success in foreign affairs, eventually grows from this social policy. The German government is in a position to judge how its actions react on public opinion both at home and abroad. It is powerful enough to shift to a more moderate course if need be. If it chooses to pursue in Austria a policy more radical and reckless than that originally followed in Germany, a policy moreover which is bound to be detested by influential groups all over the world, it is obviously ready to pay the price of some international condemnation for other very tangible results.

It obviously knows that by its social policy it gains the open support or, when circumstances do not allow that, the secret cooperation of a growing sector of people in countries where desperate economic conditions compare unfavorably with the alleged paradise of employment, rearmament and antisemitism. This statement may seem exaggerated. Yet one has only to look at the eastern European countries, especially Hungary, Roumania and Greece, in order to realize that there an increasing group of people think of German predominance no longer as a national threat

but as a social promise. For the time being, the groups in power in these countries make every effort to satisfy social needs by adopting some planks of the National Socialist platform without accepting National Socialism wholesale. The result cannot yet be judged. The Austrian experience, however, suggests that this method is at least dangerous. Apart from national and historical peculiarities Austria seems to indicate that resistance is weakened when based on imitation, and that yielding to primitive creeds and misguided instincts results not in satisfying people but in stirring them up. As governments try to take the wind out of the sails of National Socialism they only convince an increasing number of their own people that what is done in Germany and is now repeated in Austria must be the best recipe for social and national security. The resultant propaganda for totalitarianism is completed by the powerful advertising done by state and party in Germany, advertising which by distorting the facts is able to deceive Germany's neighbors.

II

When social and national sympathy for National Socialism coincide, as is generally the case with the German minority in Czechoslovakia, German influence is nearly irresistible. This is shown by the figures of the latest communal elections in Czechoslovakia. The Sudeten German party gained between 80 and 90 per cent of the German votes. Some of them were certainly due to intimidation, economic pressure, secret terror and open violence. Yet the elections themselves took place under the protection of Czechoslovak police, while the government displayed its military power, especially in the border region. Democratic procedure was formally maintained, and public control of the voting places was unhampered. The result is the more impressive if compared with the last similar election in Germany. In 1933, after Hitler had become Chancellor, the National Socialists went to the poll in much more favorable circumstances. Open terror, partly exercised by the administration itself, partly acquiesced in by public authorities,

suspension of free speech and free assembly for the opposing parties, every device of government propaganda for the favored party worked together to give the National Socialists an enormous advantage, and yet they did not even reach the 50 per cent mark. Nevertheless they were able afterward to smash the opposition.

In Czechoslovakia the few moderate elements of the German minority are unfortunately negligible. The strength of the resistance rests exclusively with the national and democratic tradition of the Czechs and Slovaks themselves. The country has had its internal difficulties along with all its neighbors. In 1921 it fought communism, and from 1926 to 1929 it was endangered by an even stronger fascist movement. Both were overcome without recourse to totalitarian techniques. This was due to the fact that because of the age-old quarrel between Germans and Slavs the tension between nationalities in Czechoslovakia has always been the strongest factor. Together with the better economic position of the Czech districts, this stress on the national instead of on the social issues goes a long way to explain why democracy there resists so strongly the social and economic implications of National Socialism. If German propaganda complains about communist influence in Czechoslovakia—propaganda of a viciousness which cannot be imagined if one does not see German newspapers or listen to the German radio—it is far from the truth. But it expresses facts of foreign affairs in the popular terms of a domestic problem.

For Czechoslovakia is protected by alliances which seem to give her a unique position in Europe, and most important of them is her treaty of mutual assistance with the Soviet Union. But this becomes operative only in so far as France will fill the obligations demanded in her own similar treaties with Czechoslovakia and the Soviet Union. France and Russia are both hampered in their assistance, inasmuch as they have no common frontier with Czechoslovakia. They are also handicapped in their moves against the potential aggressor, Germany. France is now practically blocked by the fortifications which Germany has built in the Rhineland,

and the Soviet Union has no common frontier with Germany. In both instances the working of the alliances depends on technical and political presuppositions which cannot be discussed here in detail. Yet whatever the tactics of the moment have to be, basically these alliances reflect the pivotal position that Czechoslovakia holds in the struggle which is now reaching its decisive point—the question of conquest or organization, of balance or predominance in Europe.

It is with regard to this particular position that the weak points in Czechoslovakia's political defense should be visualized and her chances gauged. The essential difficulty is of course the existence of that large German minority, for it lays the country open to a technique of boring from within against which no international treaties give any protection. In spite of statements of Sudeten German leaders to the contrary, the militant group within the Henlein movement is undoubtedly disloyal to the Czechoslovak state as such. In this it is openly encouraged by the German government, as witness the two leaders of National Socialism in Bohemia who disregarded their word of honor and fled to Germany in order to be made members of the German Diet, or the wreath which the German Chancellor sent officially to the funeral of two party functionaries who were shot while attempting to disregard orders of the local police. This influence from outside surpasses the borderline of nationalities, which in any case is hard to define. If proportionality of jobs in the central administration, as is now granted in form to the German minority, is to be applied in fact, virtually every branch of government will be open to sabotage, treason and other forms of destruction.

Nor is this all. The Czechoslovak government is under heavy pressure, especially from Great Britain, to concede more than it would be willing to give on its own account. In order to strengthen the international position of their country the leaders are bound to endanger its internal cohesion. The stronger it seems internationally, the weaker it grows nationally, as it deprives itself of the forces of democratic resistance. There is no way out of this

dilemma, for to disregard the advice which is so vigorously given may mean to sacrifice the unique protection implied in the French alliance, whereas accepting the advice may very well bring on the destruction of the state from within while it is still protected from outside.

Yet these are still tactical difficulties. The greater problem ensues from the general disintegration of that postwar order for which Czechoslovakia stands. This order was abandoned long before it was to be tested here. The very existence of this new state can best be justified, and as a matter of fact always has been by its spokesmen, as part of the new European system which is described by the terms collective security, minority protection, democratization of international relations—the system, in other words, which tried to replace the European concert by the League of Nations, and the rivaling alliances of great powers by the peaceful cooperation of all countries. On the other hand, it can best be attacked, and indeed is continuously so attacked by German propaganda, as part of the decaying world described in the familiar formulae of dictated peace, denied self-determination, Balkanization of central Europe—the world, in other words, against which the new nationalism is fighting under German leadership. Czechoslovakia's international position has largely shared the fate of that postwar order. The sad experience of almost twenty years, that there is no compromise between these two camps and their concepts, throws its shadow on the future of the country. Moreover, the ascendancy of the attacking group is a matter of historical record. It cannot be denied that the treaties of 1919 have lost what moral justifications they had after the war. The decline of their defenders is only temporarily hidden, in form more than in fact, because individual states on that side have increased their armaments and their diplomatic initiative. In addition, the defenders of the status quo have had to return to the technique of bilateral agreements, have had to eliminate the League of Nations, and thereby partly accept the thesis of their enemies, which is more convincing on a world scale and therefore more successful.

Thereby they could not help also undermining the position of Czechoslovakia which at the same time they tried to defend.

Hence a lasting solution of the Czechoslovak problem, at least within the territorial status if not within the general system to which it belongs, is most unlikely. The German minority, left with full local self-administration, will definitely drift into a totalitarian set-up. It has already done so outside the field of local government, even under the restrictions of Czech resistance and democratic control. Such a process may go on, at least for some time, without openly violating the law of the land. Those states in Germany, for instance, which turned National Socialist under the Weimar republic, became dangerous centers of totalitarianism years before the whole country took that course. Today the development in Danzig shows the extent to which international and internal safeguards against a dictatorial rule can be circumvented. In the Sudeten area that trend cannot be stopped except by the Germans themselves, yet they can no longer do so, in defiance of orders from Germany. Therefore, if the existence of an almost totalitarian system within a democratic republic is unavoidable, peaceful cooperation between majority and minority in the long run is inconceivable.

Theoretically there was one way that Czechoslovakia could have fortified her precarious position at Germany's doorstep. That was by strengthening cooperation within a system of collective security in the Danubian sector, where—as the Czechs themselves stated it—the balance of power is no longer confined to the great nations but includes minor countries. In order to answer the question whether there is still a chance for such an attempt, after Austria has disappeared, one has to look back to previous endeavors of this kind.

Masaryk planned to form an alliance of all the succession states, Poland and if possible the Balkan countries. His idea was not realizable, so Czechoslovakia entered into bilateral alliances with Yugoslavia in 1920 and with Roumania in 1921. The latter countries bound themselves by a similar treaty, and out of these in-

struments the Little Entente developed. It was a defensive group, formally directed against Hungary, but in its practical policy also against the restoration of the House of Hapsburg and against a German-Austrian union. Though it developed into a new and promising machinery for economic cooperation, its leaders were unable to overcome its exclusiveness. Neither Austria nor Hungary could be brought into it, despite many efforts made in that direction. Basically the nations concerned were too much concentrated on protecting and stabilizing their independent existence. For the Little Entente that endeavor was identical with maintaining the status quo. For Hungary it meant revision of the Treaty of Trianon. For Austria it meant frantic attempts to develop enforced independence into a national policy for which it had to lean for support on sources outside the Danubian area. Nevertheless the trend was toward general rapprochement. The disruptive influences came from outside.

First, however, efforts from outside too were bent on the policy of restoration. When the customs union between Austria and Germany was rejected in 1931, the countries concerned realized that something constructive had to be done in order to maintain the political structure and territorial status of central Europe. The statute of the Little Entente which established that body as a new international unit, its members acting together especially in foreign affairs, was prepared in 1932 and signed in Geneva on December 10th. For France, Tardieu worked out his plan of a system of preferences among central and eastern European countries. The Commission of Enquiry for European Union, set up by the League in 1930, also took up the problem of economic cooperation in central and eastern Europe. The Stresa conference, called to submit to this commission "proposals as to measures required for the restoration of the countries of central and eastern Europe," collected valuable data and made far-reaching suggestions. As a political corollary, the Danubian non-aggression pact became the object of prolonged diplomatic negotiations. Yet nothing tangible came out of it. A relatively favorable period passed unused. With

the emergence of the Rome-Berlin axis and the disappearance of Austria, it is definitely gone.

The only plan which developed into something real and workable was submitted to the League of Nations by Italy in October 1933. It was carried out, however, by Italy alone, and on a much smaller scale, in the Rome Protocols of March 17, 1934. Through them the so-called Rome Bloc was established. It cut Austria and Hungary off from a general scheme and bound them, politically as well as economically, only to Italy. As Italy was opposed to the Little Entente and to any idea of cooperation by which the former territory of the Austrian-Hungarian Empire might become closely connected, this grouping worked as a disruptive influence. On the other hand, it was successful, because through it Italy, at considerable sacrifice, made a practical contribution to easing the economic difficulties of Austria and Hungary. As Italy remained vitally interested in Austrian independence she continued to pay its economic price, and later extended to Yugoslavia some of the preferences granted by the Rome agreements. Thereby she weakened the Little Entente and counteracted the last minute efforts of the Prime Minister of Czechoslovakia to expand that triangle into a real Danubian grouping. The Ethiopian war, during which the Rome Bloc proved its political usefulness, started entirely new developments which definitely ended the opportunities missed before.

There was one more element of international cooperation with which Czechoslovakia was especially concerned, and that was minority protection. As Austria was the territorial key position for the maintenance of the status quo in central and eastern Europe, so minority protection was the psychological presupposition for peace there. It was attained by what may be called an internationalization of tolerance. For some time the system of special treaties which were under the guarantee and supervision of the League of Nations worked rather satisfactorily. Yet national ambition proved stronger than international responsibility. The protection of minority groups unfortunately became more and more the concern

of those powers to which they ethnically belonged. Finally the Polish government in 1934 challenged the whole scheme. It demanded that obligations identical to those which it had accepted—most unwillingly to be sure—should become incumbent on all members of the League of Nations. When this sensible suggestion was not accepted Poland refused further cooperation in protecting minorities. For this onesided renunciation she was formally rebuked by Great Britain, France and Italy. Yet there the matter rests, and meanwhile the fate of Jews, Ukrainians and even Germans in Poland tells the story of another failure in international cooperation. Today the League is entirely out of the picture. Minority protection is but a move in the game of power politics. Germany protects her minorities in Czechoslovakia, yet disregards them in Poland and forsakes them in South Tyrol. For the Polish minority in Czechoslovakia, Poland claims rights which she would not even dream of for the Poles in Germany—and so on. The minorities that could have been links between the different nations of central and eastern Europe have become pawns of competing governments. Their protection, which was an implicit principle in the settlement of 1919, is now a mere matter of expediency. Another main support of the whole structure is thereby broken.

III

This whole disintegration has been so piecemeal that it is difficult to determine any definite point where it could have been stopped. When it culminated in the incorporation of Austria the psychological, political and military processes were already finished. There were other moments, however, when matters came to a climax. Even then, acquiescence was the only answer.

Apart from the League of Nations, the strongest single guarantee of the status quo in Europe was French military superiority. It was insured by the provisos of the Treaty of Versailles which ordered German disarmament and the demilitarization of the Rhineland. The latter was especially enforced by the Treaty of

Locarno in 1925, which reiterated Articles 42-43 of the Peace Treaty, transforming them from a dictation into a mutual agreement. At that time Germany succeeded in keeping her eastern European frontiers out of that collective guarantee, and France, for the sake of her own security, accepted that ominous differentiation. The west became stabilized, the east remained dynamic. In Germany this was regarded as a great diplomatic success, and both Poland and Czechoslovakia had to be compensated for their loss of security by special treaties in which France promised them assistance in case of German attack. As the German western border was still unprotected, such assistance seemed to be relatively easy and certainly effective.

In 1935 Germany, by repudiating the military clauses of the Treaty of Versailles and introducing compulsory military service, openly threatened French military hegemony. It was a momentous step, deciding France's future position in Europe. Yet except for the forming of the so-called Stresa front, which was a loose agreement for consultation and cooperation among Great Britain, France and Italy, and for a rebuke by the Council of the League of Nations, nothing happened to Germany. In the joint resolution of Stresa, Great Britain and Italy reaffirmed all the obligations assumed under the Locarno Treaty and declared their intention, "should the need arise, faithfully to fulfil them." Great Britain then made her naval agreement with Germany on June 18, thereby realistically conniving in treaty breaking. France, knowing that she could not obtain international assistance on this issue, did nothing against Germany, but in May she signed the treaty of mutual assistance with the Soviet Union, as did Czechoslovakia.

A year later the Rhineland was remilitarized and the Locarno Treaty torn up. Again France did not dare to act single handed, and her partners were not inclined to regard the presupposition of military assistance as fulfilled. Proclamations, negotiations, again a resolution of the Council of the League in formal fulfilment of its task, accompanied the greatest single move by which Germany changed postwar power relations. France lost the posi-

tion from which she could come to the assistance of her eastern allies, and thereby lost her predominance in Europe, which she regarded as the only reliable means of maintaining her own security. Though Germany avoided any open threat to French territory—tactics which enabled Great Britain to declare that the *casus foederis* of the Locarno Treaty had not materialized—she threatened the whole system of French policy. No issue could possibly be more vital for France, not even open attack in the east. Yet France did not fight. Certainly by acquiescing she maintained the peace of Europe, but it had definitely ceased to be her peace. How can France be expected to defend other countries' security more vigorously than her own?

Are there any other powers left which can be expected to defend the status quo in central and eastern Europe if it can be changed "peacefully"? To answer this question would mean to analyze world politics in their relations to that area, to appraise the British stake in them, Russia's strength and the combined power of resistance represented by the smaller nations which are within range of National Socialist expansion. In the context of this attempt at a political diagnosis, a few remarks must suffice.

Whatever the motives of British policy, it holds compromise as an end in itself, while for the German government compromise is a tactical means for gaining time. The German Chancellor himself has in many instances given proof of that. In rearming he openly declared a definite maximum, yet it was exceeded within a year. In repudiating the military clauses of the Treaty of Versailles he voluntarily confirmed the Locarno Pact, yet a year later it was renounced. Then he proclaimed an end to the policy of surprises, only to take Austria a year later, thereby violating the agreements of July 11, 1936, with Austria and of October 25 with Italy.

The Soviet Union is not in a position to wage a preventive war on its western border because it is the only power whose fight would call forth the attack of a definite combination, in this case the anti-Comintern triangle of the Berlin-Tokyo Pact of 1936

which Italy joined last year, and would also antagonize Poland, Lithuania and Roumania which for geographical reasons cannot remain neutral in such a clash, and the unpredictable force of anti-communist feelings all over the world on which fascism feeds.

Those smaller countries which are not forced into line will try to avoid action in case of any war. The frantic flight into a new neutrality is the significant feature of what the Scandinavian countries, the Baltic group, Belgium, the Netherlands and Switzerland are doing today. They are disclaiming all responsibility under a system of collective security and sanctions, and gladly sacrifice mutual protection for the precarious position of onlookers. Only those who are too close to the center of unrest are trying to find security with the strongest: Hungary, Yugoslavia and Greece have turned toward the Rome-Berlin axis; Bulgaria, though favored by the Balkan Entente, has reasons of present economic interest and traditional sympathy for entering the German orbit; Roumania may try to imitate Hungary, who hopes to expedite her resistance against National Socialism at home by cooperating with it abroad, certainly futile tactics.

This then is the discomfiting result of a sketchy survey: the Rome-Berlin axis has replaced France as the dominating influence with the smaller European nations, and Great Britain is now trying to check and canalize that influence, as she formerly tried to restrict France. Yet in order to establish a balance of power she would have to throw her full weight onto the scale with France, whose side of the scale has been going up ever since Germany rearmed. It is obvious that British policy is reserving that decisive action for the one case of German attack against France.

Except for this limited British influence, which tends toward stabilization after some adjustments have been made, there is no active or creative policy discernible in the realm of collective security, respect for international obligations and mutual tolerance. Unfortunately the only dynamic principle, stirring the hope, gaining the admiration and catching the imagination of more and more groups in Europe, is German expansion. As Italy is not yet

able to divert her strength from Spain and Africa, but is ready to second German moves in central and eastern Europe, the axis is definitely an asset for German foreign policy. Furthermore, the methods which this policy uses make outright territorial conquest unnecessary—the only contingency in which the collective system of 1919 could possibly be brought into action. The disintegration of this system is a challenge which National Socialism accepts.

It may well be that the development in Europe as outlined above will take the form of local thrusts which, by keeping the form of peace, would provide the guarantors of the status quo with the necessary pretexts for keeping out. On the other hand, events outside of Europe may easily change the whole trend. Yet for the time being German influence, not necessarily identical with German power and potentialities, is predominant.

After all, this fact in itself need not be disturbing. Germany is the largest European nation, and therefore the unfolding of her power might be regarded as a natural process. Yet there are points where this natural process is bound to develop into catastrophe, as history shows. Unfortunately it is not within the purview of totalitarianism to use self-restraint, nor is voluntary restriction a known trait of German policy. Furthermore Germans, especially under dictatorship, are good organizers yet bad rulers, powerful propagandists yet poor psychologists. International indulgence, which they will misjudge, is going to drive them into exaggerations, and that in turn will finally provoke resistance. Nationality problems in the whole area of the east, now open to German predominance, cannot be solved without flexibility, yet success breeds stubbornness which turns into defeat. German predominance then, as it looms today in Europe, seems to contain elements of self-destruction, similar to those which some people think were responsible for the last war and its results.

WHY AUSTRIA PERISHED

BY OSCAR JÁSZI

I

THREE years ago, when for the last time this writer looked over the Danubian scene and especially the situation in Austria, he wrote as his final conclusion the following: "There can be no doubt that Austrian Fascism is the weakest link in the chain of European dictatorships. Not only the strong and proud Austrian proletariat hates it, not only the more advanced middle classes resent it, but also large masses of the peasantry oppose it because they are won over to the idea of the *Anschluss*. It can only last as long as the European balance of power artificially maintains its anachronistic and impossible existence."¹

This was not a prophecy at that time. It was the conclusion drawn from a long series of facts and was shared by most of the impartial foreign observers. It is therefore strange to see that since the Hitler coup public opinion has changed so considerably that even some competent experts describe the dramatic events of last March as nothing but the violent act of the Führer against gallant little Austria. This attitude can be explained by two factors. One is the legitimate indignation of all decent people at the brutalities of the Nazis. The other is the psychological law according to which we exalt the bright side of a condition lost forever. Lamenting the fate of Austria, most people think not so much of the state which has now succumbed, with its impoverished population, its continual financial disasters and scandals, and its long series of social upheavals, as they do of the splendors of the former Hapsburg monarchy.

Yet even the glorification of the Dual Monarchy has about it something artificial and melodramatic. During the nineteenth

¹ *World Unity*, vol. 15 (March 1935) p. 368.

century many independent spirits, both in Austria and elsewhere, recognized the morbidity of the imperial structure. They felt that the empire had lost its contact with the creative forces of the period, and that Vienna had begun to assume the role of a Venice or Toledo, living on past glories. All the formative forces of the younger generation, both German nationalists and Marxian socialists, began to regard the Hapsburg empire as an obstacle to their ideals.

Otto Bauer, surely the most representative man of postwar Austrian socialism, expressed an overwhelming opinion in his party when he wrote: "*Grossdeutschland moins les dynasties*, so had Lassalle formulated the national program of the beginning Social Democracy. And when in 1866 the German-Austrian working class began to stir, it also accepted the all German republican thought . . ."¹

On the other side of the fence, Adolf Hitler expressed the feeling of all dissatisfied prewar German nationalists: "I became convinced that this state must necessarily hinder and cramp every really great German and foster on the other hand every un-German. . . . It was odious to me, this conglomerate of races which the capital of the Empire has shown, this mixture of Czechs, Poles, Hungarians, Ruthenians, Serbs, Croats, etc. and among them the eternal parasite of mankind . . . Jews and Jews again."²

The conviction became almost universal that the death of the old emperor, Franz Josef, would lead immediately to the dissolution of his "impossible empire."³ Louis Kossuth had even foreseen the dynamics of the process when he wrote in 1888: "The German provinces of Austria must fall by themselves into the orbit of Germany . . . There will be persons who will live to witness the day when Alsace Lorraine will be exchanged for the German provinces of Austria. By exchange I mean that the former

¹ *Die Österreichische Revolution* (Vienna 1923) p. 51.

² *Mein Kampf* (Munich 1933) p. 135.

³ In his book, *The Dissolution of the Habsburg Monarchy* (Chicago 1929) the present writer has collected many representative opinions to this effect; cf. pp. 7-13.

will be regained by the French, and the latter will be taken by the Germans. History has its own logic."

II

Yet it would distort the historical perspective if one were to accept the hasty generalization that the Hapsburg empire was only an artificial creation, a kind of *fidei commissum* (as Metternich once qualified it). The truth is that the monarchy accomplished a gigantic historical mission: it defended the Holy Roman Empire against the Turks and gave for a long period political and cultural organization to some ten nations and many smaller nationalities (a population of 51 millions on an area of 260,000 square miles) which, without its assistance, would have annihilated themselves in continuous tribal and feudal strife. Indeed, the Hapsburg monarchy signified the *Pax Austriaca*, the continuation of the *Pax Romana*.

From the mountains of Vorarlberg to the Russian frontier, from northern Bohemia to the Adriatic, a common pattern of civilized life was established and the German language became a sort of *lingua franca* which made international communication on a large scale possible. The advantages of a vast customs union were manifest. Two world famous universities and a number of less known but solid educational institutions spread western culture into the remotest parts of the monarchy. And Vienna became for Central Europe what Paris used to be for the west, a *ville de lumière*, a melting pot of all the nations, a center which developed marvelous manifestations of music and art and the most human of all sciences, medicine.

Yet this brilliant civilization collapsed, mainly because there was no place in the Hapsburg empire for the two leading ideas of the nineteenth century: democracy and national self-determination. The short popular explosion of 1848 was crushed in blood, and the Bach System made a last effort to carry out a policy of complete centralization and Germanization. And when this attempt collapsed at the battlefields of Magenta, Solferino and fi-

nally Königgrätz, then Austria, driven out of the German Bund by Bismarck, tried to reorganize its antiquated structure under the pseudo-constitutionalism of the Dualist System. The fundamental idea of the Compromise of 1867 was the rule of German bureaucracy and bourgeoisie in Austria and that of Magyar feudalism in Hungary. This rule, carried out against the will of the great majority of the population, drove the dissatisfied nationalities into irredentism. Especially did Jugoslav separatism assume particular gravity, so that it constituted one of the chief causes of the World War.

The collapse of the Dual Monarchy in this life and death struggle was not a purely mechanical process. The World War simply accelerated the inner forces of decay. The empire was compelled to fight a double war against its foreign enemies and its rebellious minorities. As a matter of fact, the death knell of the monarchy was first tolled not by the peace treaties of the victors, but by the young emperor himself, who made a last desperate effort to save his throne. In his famous Manifesto of October 1918, Emperor Charles declared that Austria should be transformed into a federal state (*Bundesstaat*) in which every nation should form a unit on its own territory. But the proclamation came too late: every nation of the monarchy chose complete independence. Although the peace treaties committed many unnecessary cruelties and disregarded economic necessities, yet in their essence they only sanctioned the new equilibrium created by the nations themselves.

III

Thus Austria remained alone: a bleeding, starving country, on infertile, mountainous territory, a small, wretched remnant of the imperial glory, with a population of about six and a half million. Vienna, the former banking and commercial center of a world empire, was practically paralyzed, and with its disproportionate population, almost one fourth of the whole, looked like an enormous hydrocephalus. The tragic role of Austria was to be what Chancellor Schuschnigg called the "international beggar."

Famished soldiers returning from the front menaced the security of the citizens. Long before the peace treaties came into existence the new states entered upon an armed occupation of the lands which they claimed. There were skirmishes in the Sudeten district and frontier battles with the Jugoslavs. On the one hand stood the growing menace of neighboring imperialisms, on the other the danger of the smoldering Bolshevik revolution. When the adventurous regime of Béla Kun gained a short-lived victory in Hungary his emissaries waged both an open and a hidden struggle against the coalition government in Austria, which was headed by moderate socialists. Every province tried to become an independent unit, closing its frontiers to the central government. In the first half of 1919 Vorarlberg proclaimed its union with Switzerland, Tyrol with Germany, and Salzburg with Bavaria.

Whereas the other nations of the former monarchy aspired joyously toward their new nationhood on their historic soils, no such feeling existed among the Germans toward the torso of their former world empire. This new Austria had no soul, no patriotism, because the Germans felt themselves rather the losers of privileged positions than members of a national state. Immediately at the beginning of the new era Dr. Victor Adler, the great founder of the Austrian Socialist Party, said: "Austria should unite with the neighboring countries in a free league of nations, if the other peoples are ready. Should the others reject this idea or lay down conditions which do not take note of the economic and national needs of our country, then the Austrian state . . . will be forced to join the German Reich as an additional federal state. . . ."

Danubian Federation or Anschluss—these were the only possible alternatives, at least in theory. With a hopeless Austria, and with the new nation states haughtily exulting in their new freedom, a reasonable compromise on a federal line was out of the question. All the German nationalists and all the socialists felt the reality of only one great issue—Anschluss, union with the new German republic, the fellow sufferer in the common tragedy and

manifest leader of the future. It was in line with the socialist ideology and the pan-German agitation.

In the last decades of the nineteenth century a pan-German irredentism had been propagandized by Georg Ritter von Schönerer, H. K. Wolf and their associates. In all its points this political creed can be regarded as the matrix of present-day Nazism. They proclaimed that they wished to unite Austria with Germany under the rule of the Hohenzollerns. The Roman Catholic Church, which was accused of efforts to support the Slavs, was crudely attacked, and the *Los von Rom* movement was initiated. A rabid antisemitism was organized, proclaiming Jews the arch-enemies of the German rebirth. The North German race was glorified as the savior of mankind. And although the practical effects of the movement were not conspicuous, it exercised a powerful influence on the younger generation and contributed to the ruin of the Liberal Party. The only cause for the relative unsuccess of the movement lay in the fact that the whole power of the state, of the Roman Catholic Church, of the army, and of the bureaucracy was opposed to it, and that the policy of Bismarck held the Anschluss movement in disfavor.¹

Now, when Austria had become independent and had been reduced to a comparatively dwarfish size, it was quite natural that the large majority of the Germans should become enthusiastic supporters of Anschluss. At the present time, when sentimental reaction obscures this issue, it is important to emphasize the fact that Professor Fay, John Gunther and certain other competent observers are right in saying that at the beginning of the movement it was backed by at least 80 to 90 per cent of the population. Even those who lived through the history of the Anschluss movement would be surprised by its spontaneity and tenacity if they refreshed their memories by reading its minute and conscientious review from the pen of Miss M. Margaret Ball.²

The provisional national assembly of Austria, November 1918,

¹ Cf. Friedrich Hertz, *Nationalgeist und Politik* (Zurich 1937) pp. 390-91, 408-09.

² *Post-War German-Austrian Relations* (Stanford University 1937).

and later the constituent assembly had already adopted in the first article of the constitution the principle that "German Austria is a constituent part of the German Reich." And when the first resistance appeared on the part of the victorious allies, a note was presented to President Wilson, November 1918, asking for acknowledgment of the union in accordance with his principles. And although it cannot be doubted that a section of the Christian Social Party, the second largest group in the first national assembly, paid only lip service to Anschluss, yet their silence shows eloquently that the overwhelming majority of public opinion stood solidly for the union. Germany was somewhat less boisterous in her answer to her Austrian brethren, but article 61, paragraph 2, of the Weimar Constitution reiterated the principle. In various provinces of Austria widespread agitation began for the Anschluss, and in spite of the admonition of the Viennese government, intimidated by the pressure of the Allies, Tyrol and Salzburg held plebiscites proclaiming by overwhelming majorities the necessity for union with Germany. In the subsequent years the agitation continued both in the pan-German and in the socialist camps. In 1925 a German People's League was constituted with membership of a million. In the same year 12,000 non-commissioned officers of the Republican Defense League made an enthusiastic demonstration in favor of the Anschluss. Other organizations of different type and color followed. And as the resistance of the victors continued (it should be remembered that in the Peace Treaty of Saint-Germain not even the name of German Austria was allowed) many serious efforts were made from 1926 to 1929 to unify the legal and educational systems of the two countries.

It was only a logical continuation of all these endeavors that the governments of Germany and Austria informed the former Allies in March 1931 that they intended to form a customs union. And although the two German states invited all other nations to join them in this union, France and her satellites vehemently opposed the plan. Diplomatic pressure and the subsequent crash of the Credit Anstalt induced Austria to abandon the scheme.

The whole position of the Anschluss problem changed with Hitler's coming to power. The united front of the movement broke down. The annihilation of the German labor movement showed to Austrian socialism what it could expect from an Anschluss under Nazi rule. All the socialist representatives of the Executive Committee of the Austro-German Arbeitsgemeinschaft resigned and declared that "in the interest of millions who would desire Anschluss to Germany, but not to a prison house, who are turning away today from a barbarism which dishonors Germany, true friends of Anschluss must withdraw from the movement until the idea can again be made morally comprehensible" (April 1933). The attitude of the Christian Socialists also changed. All the hidden resistance against Anschluss now assumed a more outspoken form. Austrian Catholicism realized what its fate would be under a system which crushed the great Catholic Party of Germany, the Centrum. Needless to say, Austrian Jewry, the most influential commercial and financial element of the country, lost all its sympathy for Anschluss, and union was opposed also by the old Hapsburgist officers and officials and by a considerable part of Austrian capitalism, which was afraid of the superiority of the German industrial structure.

The long series of illegal Nazi activities in Austria, the criminal brutality of their terroristic measures, the haughty interference of the German government in Austrian affairs, made the anti-Anschluss current increasingly strong. The anti-Nazi ideology began to emphasize Austrian patriotism, the independence of the country and the necessity of the restoration of the Hapsburgs. It became a fashion to confer honorary citizenship in towns and honorary membership in cultural organizations upon Archduke Otto.

IV

Could these forces have been united into a single front for the independence of Austria against Nazi aggression? Lamenting the Austrian tragedy, liberal and socialist writers have elaborated the

thesis that such a united front would have been perfectly feasible if the "gallant defenders of Austria," Chancellors Dollfuss and Schuschnigg, had not committed the fatal mistake of destroying Austrian socialism instead of making an ally of it. Mr. G. E. R. Gedye expressed this opinion categorically, saying that Dollfuss and Schuschnigg "would go down to history not as the men who saved . . . but as those who destroyed Austrian independence."

Of course one can argue that the anti-Nazi forces, solidly united, might have repelled Nazi aggression. Forty-two per cent of the population of Austria and two-thirds of the population of Vienna were socialists. The Christian Socialists, too, would have added a large contingent to the fight for Austrian independence. The international connections of socialism, Roman Catholicism, and liberal journalism, could have aroused an enormous public support for the movement all over the world. As a matter of fact, most of the liberal and socialist writers assert that if the plebiscite plan of Schuschnigg had been carried through it would have given to the Chancellor a 60 to 65 per cent majority. Though the Schuschnigg plebiscite was intended to be as dishonest and full of dictatorial tricks as the popular "votes" of Hitler,¹ let us assume that Schuschnigg in the critical time commanded a numerical majority in Austria perhaps as large proportionally as the majority of the Czechs and the loyal Slovaks over the irredentist elements of their country. Therefore one could argue that if this had shown the same solidarity, the same heroic spirit as the Czecho-Slovak, Hitler would probably have refrained from aggression.

In order to understand the weakness of the anti-Anschluss forces we must comprehend the mass psychology of the whole period. The fundamental problem of Austrian independence was this: was a sincere cooperation attainable between the two great forces

¹ Cf. the reports of Gedye in the *New York Times*, March 10-12, 1938. Recently M. W. Fodor, in "Finis Austriae," *Foreign Affairs*, vol. 16 (July 1938) p. 596, has asserted that the provision for printing only "Ja" on the ballots was changed a few hours after it was announced, and that a free and secret balloting was proclaimed. Yet even if this is true the fact remains that no serious plebiscite can be undertaken in a dictatorship when the whole system is menaced.

of the country, the urban proletariat and the peasants? Otto Bauer saw at least the negative aspect of this problem: "It was impossible to govern the great industrial territory against the workers; it was equally impossible to govern the great agrarian territory against the peasants." This means that without an honest compromise the new Austrian state could not live as a democratic republic. Yet overwhelming social and ideological forces increasingly frustrated a real cooperation.

In spite of their small relative majority in the first constitutional assembly, the Social Democrats had a dominating position which they preserved until November 1920, when the socialists withdrew from responsibility and the first purely bourgeois government was formed. The leadership of the socialists went to the radical left wing of the party. The influence of Otto Bauer grew, that of Karl Renner decreased to the zero point. The Socialist Party of Austria had been since its origin a strictly Marxian party, but was led by able leaders in a spirit of reasonable compromise. At the beginning of the war the party had assumed a "patriotic" attitude, proclaiming that the country was in a state of self-defense against czarist autocracy. The enormous sufferings of the masses, however, and the growing corruption of the military administration made them revolutionary. Public despair found an outburst in the assassination of the Prime Minister, Count Stürgkh, by Friedrich Adler, son of the founder of the Socialist Party (October 1916). The left wing element developed a doctrine usually called Austro-Marxism, which elaborated on the line of the "Second-and-a-half International" a strictly revolutionary program, a kind of intermediary between the old Second International and the Communistic International of Moscow. They used the violent phraseology of the impending world revolution, though they were realistic enough to understand that a social revolution in Austria under the conditions then existing, the country without the necessary foodstuffs and surrounded by the hostile succession states, would have led to military occupation.

Yet there were high expectations that the Bolshevik revolution

in Russia would assume in the near future the dimensions of a world-wide proletarian revolution. Austrian socialists were scarcely aware of the fact that the extreme dissatisfaction of the masses was far more a revolution in the military barracks of the hungry, ill-treated soldiers than the beginning of a social-economic upheaval. They used the Marxian pattern of revolution without the previous gigantic work of propaganda done in Russia by Lenin and his comrades and by other professional revolutionaries trained among the sufferings of exile and Siberia. This extreme verbal revolutionism was in curious contradiction to the genuinely democratic and peaceful temper of the leaders. Careful observers agree that back in 1919 the socialists could have acquired the Alpine Montangesellschaft, the pivot of Austrian industry and later of Nazi agitation, with a moderate pressure. They did not try it. The fourteen castles of Prince Starhemberg were not expropriated, and this immature disciple of Mussolini and Hitler was left free to organize his feudal retinue against the republic. Under the acute tension socialism adopted many of the symbols and patterns of the Russian Revolution without the real driving force of that movement. Very soon a network of workers' and soldiers' councils spread throughout the country, partly as an instrument of the legal administration, partly as an independent factor, sometimes hostile to it. These organizations were regarded as accomplishing a useful double function. If world revolution should come they would constitute the nuclei of the future transformation. If capitalism should be restored they would in the troubled time assume the role of a safety valve, giving an opportunity to the inflamed revolutionary energies to evaporate.

The Austrian bourgeoisie and peasantry were naturally alarmed by these formations. They understood only their loud and often brutal demagoguery, the continual threat of the approaching social revolution. Dr. Max Adler, a leading Marxist ideologue, greeted the workers' and soldiers' councils as instruments of the "permanent revolution."

Things were made worse by the Marxists' lack of comprehen-

sion of the needs, the traditions and the forms of life of the peasant masses. They were inclined to regard the peasantry simply as reactionary small capitalists, representatives of "rural idiocy," who could not have an equal footing in the coming proletarian republic.

The relation of the Socialist Party to the liberal intellectuals also became very tense. There was a rigid orthodoxy in the party which distrusted all opinions not of a strictly Marxian character. The primary importance of creative intellectual work was never acknowledged. An article in the *Arbeiter-Zeitung* comparing the work of a charwoman with that of the chief of a division in a Viennese hospital, to the detriment of the latter, aroused widespread indignation, especially among true liberals with a genuine social outlook.

Another important factor in the ideological situation of the socialists was the favor they gave to what was called *Krieg-Sozialismus*, which they regarded as a transitory stage to a real socialist economic order. In accordance with this doctrine they advocated the maintenance of the economic regulations of the war in a new socialist form. Big plans for "full socialization" were elaborated. As a result of this they came into conflict with both the bourgeoisie and the peasantry who fought for *Freie Wirtschaft* (free market economy) as a means of readapting the mutilated Austrian economic system to postwar conditions. All these deeply entrenched socialist convictions aroused distrust in almost all non-proletarian sections of the public. It was felt that when they spoke of a people's republic they meant only Social Democracy, that when they spoke of democracy they had in mind only preparation for the dictatorship of the proletariat.

The Christian Socialist ideology was no less rigid and intolerant than the Marxist. Christian Socialism was only the political weapon of the Roman Catholic Church. And an impartial English observer compared the intransigency of the Catholic Church with that of the Marxists: "Indeed, not only in the extent of their claims, but also in their character, they are bound to clash vio-

lently. Each claims to regulate not only conduct, but thought. Each lays down a world system and insists on orthodoxy . . ."¹ This dogmatism was the more dangerous as the Austrian church, like that of Hungary or Spain, had remained essentially a feudal and dynastic institution. Though a few praiseworthy exceptions could be noted, the church as a whole remained a bulwark of reactionary forces, the upholder of blind conservatism and of distrust for social reforms.

An antisemitic tendency had been the tradition of the Christian Social Party since its foundation in the eighties of the nineteenth century by the Burgomaster of Vienna, Dr. Lueger, though it had been mitigated by his shrewdness and good common sense. Now under the convulsions of the postwar period and of the pan-German agitation it became a raging crusade in which socialism (whose leadership was strongly Jewish) was interpreted as a machination of international Jewry.

But what made the abyss between socialists and the other parties unbridgeable was not so much the difference in their practical programs as the clash between the traditional values of the country and those of Marxian socialism. Adolf Hitler, who had a very fine ear for the sentimental reactions of the small bourgeoisie and peasant masses, describes his first meeting as a wage earner with the members of the trade unions as follows: ". . . what I heard was likely to excite me to the utmost. They repudiated all: the nation as an invention of the 'capitalistic' . . . classes; the fatherland as the instrument of the bourgeoisie for the exploitation of the workers; . . . the school as an institution for the breeding of slaves . . . ; religion as a means for stupefying the people destined to be exploited; morality as a sign of stupid sheeplike patience; and so on . . ."² Needless to say, such an interpretation of the exaggerations of Marxian propaganda hopelessly poisoned the political atmosphere.

¹ Cf. C. A. Macartney, *The Social Revolution in Austria* (Cambridge, Eng., 1926) pp. 53, 179-80.

² *Mein Kampf*, pp. 41-42.

v

Almost all that happened in Austria in her twenty years of existence made the clash between the two antagonistic parties even more acute. Space limitations forbid my narrating the whole story. All that can be done is to stress the main points which led with the inevitability of a Greek tragedy to the final annihilation of the republic.

Even at the very opening of the constituent assembly, when the republican constitution was adopted and the new state flag—red, white, red—was hoisted, the communists began to revolt against the “bourgeois” republic and to clamor for a soviet constitution. The demonstration developed into a street riot and some three dozen wounded were transported to hospitals. For several hours the leading bourgeois newspaper, the *Neue Freie Presse*, was occupied by communist bands. The incident caused a panicky feeling in the middle classes.

Of far greater consequence was the growing dissatisfaction of the peasantry. As the food supply between the new frontiers was short, the government was obliged to continue the requisitions of the war economy in a time when industrial production was paralyzed. The peasants felt themselves robbed by the capital and attributed the vexatious measures to the hostile spirit of the socialists.

Soon those middle classes and intelligentsia, who at the beginning went with banners unfurled into the camp of socialism, also became alienated. The growing depreciation of the currency caused, in 1921, a short wave of pseudo-prosperity. The great difference between the value of the krone internally and abroad enriched some of the entrepreneurs. There was an enormous activity in currency speculation and smuggling. Solid capitalists of the old type could not compete with the new adventurers. The ill-famed “black bourses” in the cafés around the official stock exchange were mostly frequented by Jewish refugees from Galicia, uprooted by the war. Also, many “aryan” gold-seekers came into the starving capital from countries with strong currency (many

Italians and Swiss) and bought out for a trifle the furniture, the linen and the *objets d'art* of the bankrupt middle class. New multi-millionaires without any connection with the country began to play the role of social leaders and art protectors, and participated in the secret game of politics. It was an excellent opportunity for demagogues to flood the country with a wave of anti-semitism. The great accomplishments of the old Jewry of Vienna, one of the most cultured in Europe, were soon forgotten. And as the transitory boom in certain industries secured fairly good wages for the proletariat, it was easy for the agitators to make socialism responsible for the bankruptcy of the native bourgeoisie.¹

The antagonism between the socialists and the other classes became almost symbolic when the Socialist Party abandoned the government and concentrated all its forces on the capital, Vienna. After 1921 the metropolis became an independent *Bundesland*. Enjoying complete autonomy in administration and taxation, "Red Vienna" looked like the stronghold of the proletarian forces. The great city developed a policy for housing, sanitation, recreation and education of the people which attracted worldwide attention. Its gigantic apartment houses gave nearly one-eighth of the population healthful and airy small apartments for almost nominal rents through a severe system of progressive taxation. And as the higher incomes are always more able to avoid taxes, the result was again that the middle-size businessmen and the intellectual professions felt themselves to be the victims of a social policy which even the richest capitals of Europe did not dare to introduce. This led again to an embittered reaction against socialism, the more so as the scientific, rationalistic and to a large extent atheistic spirit of the Viennese municipality hurt the conservative and clerical mind of the small towns and the rural districts.²

¹ Cf. Bauer, *op. cit.*, pp. 205-07, and Macartney, *op. cit.*, pp. 215 ff.

² Concerning the international controversy about the Viennese housing policy, a fair and objective estimate may be found in Charles O. Hardy, *The Housing Program of the City of Vienna* (Washington 1934).

New difficulties arose when, in the second half of 1921, the pseudo-boom of the currency depreciation came to an end and the country soon stood on the brink of final bankruptcy. Repeated efforts to cure the situation were unavailing. In the summer of 1922 monetary depreciation assumed colossal proportions and with it the cost of living rose menacingly. In August the state was unable to procure the necessary foreign exchange for the indispensable supplies of food products, coal and raw materials. This was the time when Mgr. Seipel, a priest of ascetic character, keen vision and great political shrewdness, undertook his mission of restoring the financial equilibrium of the state with the support of the League of Nations. This action was successful and led in October 1922 to the Geneva protocols. A loan of 650,000,000 gold crowns was guaranteed; a commissioner general was appointed for carrying on the necessary reforms and a committee of control was set up. In the meantime, Austria assumed the obligation to "abstain from any negotiations or from any economic or financial engagement calculated directly or indirectly to compromise its independence." The program included heavy taxation and a radical reduction of the number of state officials.

These were surely hard conditions, but the socialists went farther than a severe criticism of the proposed measures. A nationwide propaganda was organized against the loan, accusing Seipel of "having sold the sovereignty of the country for 650,000,000 crowns, of having put the country under the exploitation of international finance capital which would squeeze out the last resources of the impoverished country and would drive tens of thousands of state employees into misery." And when it became manifest that the socialists alone could not make the Geneva loan fall through, they made a last effort to mobilize the German feeling of the bourgeoisie against the "Geneva slavery." As this propaganda proved to be unsuccessful the stabilization of the currency restored the hegemony of the bourgeoisie over the proletariat. The socialists were put on the defensive and their opponents tried to curtail what was called the "functional democracy" of socialism, the administra-

tive, economic and military gains which it had made during the revolution.

The military controversy especially aggravated the tension between the classes. During the Social Democratic predominance the regular army, the so-called Bundesheer, was under the leadership of the republican general Körner, and the councils of soldiers had exercised a considerable influence over the recruiting of soldiers. With the growing political reaction the old authoritarian character of the army was step by step restored. Then came the growing struggle between two private army organizations. Immediately after the war the Austrian proletariat organized its Schutzbund for the defense of the republic. Almost at the same time Heimwehr organizations were created in several parts of the country, especially in Tyrol, Styria and Carinthia, in which ambitious local leaders united the younger elements of the peasantry and of the former army with the purpose of guarding the new frontiers, of maintaining order against disbanded soldiers, and of fighting the dreaded communist revolution. The leaders of the Heimwehr movement, whether Christian Socialists or Nazi in their conviction, were animated by the same fascist doctrine of hatred of the socialists and of the Jews, and by the conviction that democracy should be replaced by an authoritarian government of true patriots.

There was, however, no real unity in the Heimwehr movement. None of the leaders was able to organize a widely-spread mass support as Hitler did. And though a few of them represented a sincerely patriotic conception with the effort to restore the Hapsburgs, the general atmosphere of the Heimwehr had a distinct condottiere character. The leaders of the different formations often came into conflict with one another, and some of them became paid instruments of Fascist or Nazi influences.

An extremely tense situation was brought to explosion by an event of fateful magnitude. In July 1927 some members of the Heimwehr were acquitted who, in a village of the Burgenland, on the occasion of a street demonstration, had killed two social-

ists. The manifestly unjust verdict aroused tremendous indignation in the proletariat of Vienna, which communist agitators used to foment an uprising. The next day a general strike was proclaimed which led to violent excesses. The chief wrath of the masses was directed against the Palace of Justice, which was set fire and its official documents burned. The socialist leaders in despair could not check their own masses. During the whole night battles were fought on the streets and only the next day was order restored. This terrible July 15 witnessed more than a hundred dead and four hundred wounded; nearly three hundred were captured and haled into court. Each party accused the other in the most violent terms as responsible for the bloodshed. It cannot be doubted that from this time on reactionary leaders and officers decided upon the annihilation of the socialist organizations. After 1930, with the Vaugoin government, the struggle against socialist influences in the army and against the *Schutzbund* became accentuated. In 1931 several influential *Heimwehr* formations planned an armed plot against the government in order to establish their own dictatorship. The movement assumed a dangerous character but ultimately the personal jealousy existing between the *Heimwehr* chiefs made an end to the badly prepared venture.

The turmoils of the *Heimwehrputsch* and the subsequent acquittal of its leaders undermined further the authority of the state and increased the feeling of general insecurity. Another contributing factor to this was the crash of the *Credit Anstalt*, the most important financial institution of Austria, which after the bankruptcy of the *Bodencreditanstalt* in 1929 absorbed practically 70 per cent of Austrian banking activities. Its collapse was the first signal for the general European crisis (May 1931), and the government was again in a desperate position; again, as in 1922, it was compelled to beg further assistance from the League of Nations.

Meanwhile the existence of the state faced another more formidable danger. Between 1923 and 1930 National Socialism in

Austria was practically insignificant. After 1930, when Hitler received his six million votes at the Reichstag election, it grew with amazing rapidity in Austria. Large numbers of the Heimwehr and the great majority of the German students became ardent protagonists of the Nazi gospel. A National Socialist Legion was organized which later found refuge in Germany. The movement, with its countless terroristic excesses, was overtly organized from Munich.

Under these alarming conditions the first Dollfuss cabinet was constituted, in May 1932. Dollfuss, a man of great courage and energy, with a good-natured simplicity, but utterly unable to master a serious situation, did not possess a workable majority in parliament. He received only a one vote majority for his most urgent task, the ratification of the Lausanne protocol which guaranteed a new 300,000,000 schilling loan for the restoration of the disrupted financial structure of the country. An insignificant episode soon overturned the tormented parliamentary system. In consequence of a heated debate and an undecided ballot, following a strike of the railway employees, both the president and the vice-president of the National Assembly resigned. This confused and typically Viennese episode was used by Dollfuss for the suspension of the constitution, the issuance of emergency decrees and the muzzling of the press. He was on the road to a fascist dictatorship. Using the publicity of the German Catholic Congress in Vienna, September 1933, he announced, in the spirit of the Heimwehr program, the effacement of the parties, the establishment of the Fatherland Front, and the elaboration of a corporate constitution.

The Fatherland Front was a belated effort for the creation of a pure Austrian patriotism, the proclamation of the historical mission of Austria. It would be unfair to question that some sincere patriots, especially Dollfuss and Schuschnigg, educated in the old imperial and clerical ideals, sincerely believed in this conception. Also some distinguished poets and thinkers, like Anton Wildgans and Hugo von Hofmannsthal, really cherished the ideal

of an independent Austria with a cultural and humanitarian mission of her own. Yet the effort of creating an Austrian patriotism was utterly hopeless in a time when the Hapsburgs were expelled and the former "dynastic patriotism" could not be replaced by popular solidarity.

It was also evident that an independent, authoritarian, Catholic Austria would arouse the implacable hatred both of the socialists and the National Socialists, and could not be realized without a civil war. It is therefore idle to ask whether the terrible massacre of February 1934 was caused with or without the previous consent of Dollfuss. It was surely the inevitable outcome of his policy. He was driven to it by the urge of the Heimwehr for power, domination and the booty of Red Vienna. If Dollfuss had resisted he would have been ousted and other Heimwehr leaders would have carried out the plan. As a matter of fact Prince Starhemberg and Major Fey had begun the bloody job, Dollfuss ratified it and Schuschnigg justified it in a radio talk of February 13, referring to the Social Democrats as "hyenas who must be hunted out of the country." It is clear that the revolutionary resistance of the socialists was intentionally provoked, and their badly organized general strike was only a last desperate effort to save the remnants of their constitutional rights after having invoked in a spirit of utmost humiliation even the mediation of some Christian Social leaders and that of the Cardinal of Vienna.

There was also another powerful motive which prompted Dollfuss to make an end to Austrian socialism. This was the command of Mussolini. Mussolini not only hated his former comrades, but had a vital interest in the extermination of the Socialist Party, which had exposed the smuggling of weapons from Italy to Hungary in the sensational Hirtenberg arms affair the previous year. A few weeks before the Viennese civil war Signor Suvich, Mussolini's Undersecretary of State, went to Vienna on an official visit; the liquidation of Austrian socialism was a strong point in his mission as a precondition of a military alliance between Italy, Hungary and Austria.

VI

The destruction of Austrian socialism by all the forces of the new fascist state was the last decisive act in the Austrian drama. The sanguinary events in Linz, in Steyer, and above all in Vienna, the mobilization of the army and the Heimwehr, the use of artillery against the huge worker houses—the Sandleiten Hof, Karl Marx Hof, Goethe Haus, Reumann Hof, in which many women and children perished—made the four February days from the 12th until the 16th the burial days of the republic. The only force which could have protected the independence of Austria was annihilated, and the proud and heroic working class of Vienna was driven into a desperate underground opposition. The orgy of executions which followed and which the condemned leaders faced with martyr-like calm, the imprisonment of all the old popular figures of the labor movement, the destruction of all the labor organizations, the robbing of their properties, the military occupation of the municipal building of Vienna and the dignified resistance of Mayor Seitz, the overcrowded prisons and concentration camps made the abyss between the workers and the new rulers insurmountable.

Nothing hindered now the acceptance of the new, long-contemplated constitution by a submissive rump parliament. This constitution of May 1934 is a curious document. It created a new type of fascism of a theocratic brand. "In the name of God the Almighty"—so the document began—"from whom all right proceeds, the Austrian people receives this Constitution for its Christian, German, Federal State on a corporative foundation."

No better criticism of this constitution can be given than that of the American Catholic liberal who wrote: "*Quadragesimo anno* was to be put into practice. . . . In short [Dollfuss] set out to create something like—remotely like—the Jesuit state in Paraguay in a country which was by no means a colony of newly converted Indians, but rather an old, tired, and infinitely chaotic nation . . ."¹ Truly religious people were shocked by the blasphemy of

¹ George N. Shuster, "The End of Austria" in the *Catholic World* (June 1938).

portraying the coup d'état of a group of condottieri as an act of divine providence.

Behind the façade of the corporative state there was not the smallest possibility for the expression of popular will. The noble efforts of Dr. E. K. Winter, the new Vice-Mayor of Vienna, to reconcile the proletariat with the new state remained entirely unsuccessful. The so-called *Stände* were simply puppets of the government. The theatrical efforts of parades and reviews for creating a brand new fascist Austrian patriotism approached the ridiculous.

But Dollfuss crushed only one of his enemies. The other, National Socialism, could not be extinguished so easily, although the National Socialist Party had already been dissolved in June 1933. The Nazis avenged themselves very soon, in July 1934, by a poorly organized and unsuccessful plot which, however, cost the life of the Austrian dictator. The story of the assassination of this brave man remains a mystery. It has never been clearly established whether Major Fey, a partner in the Dollfuss triumvirate (the third man of destiny was Prince Starhemberg), was simply a coward or an active participant in the murder of his chief.

When Dollfuss' successor, Dr. Schuschnigg, a man of good intention, with sincere traditions, but narrow and bureaucratic, came to power, a period of violent repression followed. Several persons were executed without serious investigation. The rights of the citizens were attacked in the most brutal manner. It has been calculated that in the year 1934 more than 100,000 dwellings in Vienna alone were raided by the police. More than 38,000 persons were arrested: Nazis, Social Democrats and communists. It looked as if fascism of the German type had been introduced. The Austrian system was indeed a genuine fascist system, with the difference, however, that it was carried out in a typical Austrian way. Victor Adler used to say that the Austrian system was absolutism mitigated by *Schlamperei* (slovenliness). It could have been said equally well that the new corporative state was fascism tempered by *Schlamperei*. There was more in it of the spirit of Metternich than of Hitler. The systematic cruelty, the devilish

brutality, the Machiavellism à la Hegel, was absent from it. In spite of its many street fights and massacres (in all probability the losses of life were far greater in postwar Austria than in Germany) there remained a certain traditional *Gemütlichkeit* and lack of seriousness in the Austrian brand of fascism.

It is manifest that such a system could not stabilize itself. Its only real foundation was the armed support of the Italian dictator. Therefore the Berchtesgaden episode was absolutely unimportant; it was only the conclusion of a death sentence long ago pronounced. If one desire a concrete date when Austria's independence became untenable we must refer to the Venice conversations between Schuschnigg and Mussolini. In April 1937, in consequence of the changed international situation through the Abyssinian crisis, the Duce declared that he could not give any pledge to guard Austria against German annexationist aims, and therefore Schuschnigg should seek a reasonable compromise with Germany. To make his admonition more impressive, the Italian dictator left his Austrian colleague alone, went aboard the German ship Milwaukee, and praised the German merchant marine. And when both France and England declared themselves to be unwilling to interfere with the Austrian situation, the poor country, harassed by continuous internal strife, fell like a ripe fruit into the lap of the German Führer. A further point is worth noticing in the final act of the drama: not even in the hour of most extreme danger were the fascists of Schuschnigg inclined to restore a minimum of the rights of the Austrian workers in order to establish a common front against Nazi aggression. Their so-called Austrian patriotism was weaker than their hatred for the proletariat.

VII

After this desultory story of Austrian events the reader will understand how senseless it is to speculate, as some grave journalists have done, on what would have happened if Dollfuss and Schuschnigg had not committed the "mistake" of crushing the Socialist

Party. The answer is that if they had not acted as they did under the pressure of the Heimwehr and of the Italian dictator, other condottieri would have ousted them and taken their places. One could ask with the same profundity what would have happened if Napoleon, instead of fighting the Czar and the Austrian Emperor, had made a heart-to-heart alliance with them.

Two other general conclusions may be drawn as an object lesson from the Austrian tragedy. The one is against an extreme application of the theory of historical materialism. It cannot be doubted that economic conditions played an important role in the development of a fascist system in Austria. On the other hand, however, it seems clear that the issue of Anschluss or non-Anschluss was not primarily determined by any economic considerations but was an effort and counter-effort based on traditions, emotions, personal ambitions and power motives. A prosperous Austria and a free Germany would have developed even stronger tendencies toward Anschluss than impoverished Austria and Germany under the peace dictates. The Saar plebiscite alone is an overwhelming proof of this.

The other generalization is that a mass movement based on orthodox Marxist theory makes any evolutionary politics impossible.¹ It is catastrophic in its nature. It excludes all reasonable compromise. The dictatorship of the proletariat is its logical outcome, which inevitably breeds fascism. And fascism will subdue communism in every country which has a strong middle class and a free peasantry. More than a decade ago Franz Oppenheimer, the courageous solitary thinker, recognized the final dangers in the tendencies of Marxist thought, and the end of Austria is a strong argument for this point of view.

¹ The origin and growth of fascism as a result of the Marxian unmitigated class struggle has been brilliantly analyzed by Eduard Heimann in his recent book, *Communism, Fascism, or Democracy?* (New York 1938).

EXCHANGE STABILITY AND UNPRODUCTIVE FOREIGN CREDITS

BY JOHANN BARACS

I

IN THE process of production not only are commodities manufactured but at the same time incomes are created which are destined to purchase the produced goods. Equilibrium between the incomes and the product is brought about by the movement of prices: the price level is bound to settle in equilibrium at a point where the total quantity of goods can be bought by the aggregate money income. There may occur certain time lags, as a result of the process of saving. It is particularly possible that in a given period more goods will be consumed than have been produced; this is what happens in the case of capital consumption. On the other hand, of course, production may be in excess of consumption, in which case there will be an increase in commodity stocks. Notwithstanding these conceivable deviations, the principle holds that a balance can invariably be brought about between the purchasing power of the total money incomes and the price sum of the social product; the disproportions occur only if certain cyclical factors (which, however, I shall not discuss in detail) prevent the adjusting price movements.

This applies particularly to a closed economy. For a country which is bound up with a world market additional problems arise in connection with the exchange mechanism. If the country has a stable currency the commodity prices, by virtue of the exchange rates, are connected with the price movements abroad in a way that may disturb the relationship between incomes and social product which I have discussed above.

According to Cassel's purchasing power parity theory the rate of exchange between two currencies corresponds exactly to the

relation between the purchasing power which the two currencies possess in their own countries; that is, the commodity prices in the two countries must stand in a relation to one another that varies inversely with the exchange rates of their currencies. This theory can be accepted only with certain reservations. It would be fully valid only if the commodities could be moved from one locality to another without transport costs. This, of course, is an unreal assumption. No commodity can be transported without certain costs (freight charges, tariffs, insurance, cost of organizing the market). From this it follows that Cassel's theory can be applied to different commodities in different degrees, according to the share which transfer costs have in the price of the respective commodities. The smaller the share, the more closely the formation of the price corresponds to the assertions of the theory. The theory can be applied best to gold, even if the currencies are not based on gold, for the expense of transporting gold is exceedingly small in relation to its value; there are no tariffs, and the market for gold is the most perfectly organized of all markets. Gold is gradually followed by other commodities, down to those goods that are subject to import or export restrictions and to which the theory is not applicable at all.

Nor can the theory claim validity for the factors of production, especially not for the prices of services, since labor is almost completely immobile on an international scale. This latter viewpoint is of special importance in this connection, because international capital movements, including what I shall presently call unproductive foreign credits, are caused to a large extent by the impossibility of equalizing international differences in the income level through migration of labor to the place of the highest wage.

After all these qualifications the purchasing power parity theory can still be maintained in the following form. Mobile commodities—and they constitute the majority of goods—can show international price differences only up to the cost of transfer. In other words, every mobile commodity commands a certain price which cannot be raised lest the commodity be imported from abroad till

the price is brought down again to the import point. On the other hand, each transportable commodity has a price bottom which cannot be lowered, lest the commodity be exported. Thus we can establish for each commodity, as for gold, an upper (import) point and a lower (export) point.

It follows that a balance between the purchasing power of money incomes and the price sum of the social product cannot be achieved invariably, because the prices whose movements are supposed to bring about this balance are not unrestricted in their mobility but rise only to the import point and fall only to the export point. If the price level is prevented from rising to the necessary degree, the purchasing power of the money incomes will be greater, and if the price level cannot fall sufficiently the purchasing power will be smaller than necessary to purchase the total social product.

This conflicts with the accepted doctrine of a necessary balance between incomes and social product, which is generally assumed to be implied by definition. It is thought that there could not possibly be any deviation, because the two are merely different terms referring to an identical concept. According to this argument a disproportion between the purchasing power of paid out incomes (the money costs of production) and the price sum of the social product (the amount realized by selling the production) is tantamount to entrepreneurial income, which may turn into a deficit if the proceeds from sales fall short of the costs of production. If the income of the entrepreneur is negative there will be a consumption of capital, for no entrepreneur is able to support his family from a negative income; in order to meet private expenses he must consume part of his capital. By introducing the concept of negative entrepreneurial income the balance between incomes and social product is made logically possible. But this very concept shows that the purchasing power spent for the purchase of commodities may be in excess of the income defined as price sum of the social product. I shall use income in this sense, that is, as the purchasing power spent for the purchase of goods.

The reason why I have used the term in a sense which is at vari-

ance with the general definition (later on this reason will become more obvious) is that the concept of entrepreneurial income is of importance primarily for an analysis of the domestic economy, since business conditions depend particularly upon whether entrepreneurial income is positive, zero, or negative. I am dealing, however, with foreign trade relationships, and for these it is insignificant whether the purchases of goods that lead to a passive balance of trade are financed from income paid out or from capital consumption. In this connection, however, it is important to state that a disturbed currency can be restored to equilibrium through an appropriate change in the income ratio, or, to put it differently, under given conditions of production the income level varies with changes in the rates of exchange.

In order to emphasize this relationship I shall speak of a deviation of income from the social product. Those who are against terminological changes of this kind, in spite of the reasons just put forward, may always substitute "purchasing power spent for the purchase of goods" for "purchasing power of the money incomes."

II

From the above discussion two consequences follow. One is related to the business cycle and need only be mentioned. Granted that the money incomes which are created in the process of production are equal to the costs of production, the assumption that commodity prices cannot rise in a sufficient measure, because they must stop at the import point, implies with respect to the cycle that prices cannot cover the costs of production. Hence a situation arises which is bound to lead to depression. If, on the other hand, decreasing prices stop their fall above the point where they cover cost, because of the export point, this will provide a stimulus for the economy. The price movements we are discussing at present are not primarily a result of the cycle; they are a result rather of the exchange mechanism, but they exert a considerable influence on the cycle.

The second consequence refers to our main theme. In an econ-

omy connected with the world market if the purchasing power of the money incomes is, for reasons given above, in excess of the price sum of the social product, the additional consumption need not necessarily cause a decrease in accumulated savings, that is, in capital stock (as in a closed economy). This surplus consumption will be met by an additional import of goods from abroad, that is, by contracting foreign debts. Conversely, if the purchasing power of the money incomes falls short of the price sum of the social product, this will lead not to an accumulation of commodity stocks but to an increased export, and consequently to an acquisition of new claims on the outside world. While in a closed economy the incomes can differ from the social product only if there is capital consumption or accumulation of stocks, in an economy connected with the international markets indebtedness to foreign countries or lending to foreign countries presents additional possibilities for such a discrepancy to arise.

If the purchasing power of the money incomes exceeds the price sum of the social product, the country will contract debts or it will suffer a drain on its gold and foreign exchange reserves. If, on the other hand, the purchasing power of the money incomes falls short of the price sum of the social product, the country will acquire new credit balances with foreign countries or new reserves of gold and foreign exchange. On principle the decrease or increase of gold and foreign exchange reserves in the central bank can function in the same way as the borrowing or lending of foreign credits. I shall not now, however, deal with the movement of bullion or foreign exchange reserves, for the gold movements are likely to obscure the true relationships. Gold currencies invite the erroneous inference that a discrepancy between money income and social product can be eliminated through gold movements exclusively, and paper currencies induce us to believe that, with gold reserves lacking, the gap can be bridged only by sacrificing the stability of the currency. In this way the significance of the international capital market is in danger of being concealed. The impression may arise that the foreign credits which come into

existence along with gold movements can be borrowed or lent only for productive purposes, but not to restore the equilibrium between incomes and social product. In reality gold movements can take the place of foreign debts or credits only when the discrepancy is comparatively slight, and even within this limitation they do not offer any new theoretical viewpoints for the present topic. Hence there is no need to pay attention to gold movements, and I shall assume for the sake of simplicity that a gap between incomes and social product can be bridged merely by borrowing foreign funds or making loans abroad.

The problem of a country's currency is not simply the problem whether domestic and foreign prices are equal, for this—except for the above-mentioned qualifications—is a truism. The key question is whether, with any given set of price relations, incomes and social product are in an equilibrium position, or whether the country becomes a creditor or a debtor nation ("balanced," "passive," or "active" exchange situation). The international demand situation on which depends the answer to the question why, with a given international distribution of goods, identical prices will result in the world market, shows the following picture. If we neglect for a moment all other items in the balance of payments we see that in the equilibrium position identical values are always exchanged from one country to another, that is, the demand is dependent on the value of the social product of each country. Part of the social product is exchanged for foreign commodities, but after the exchange has taken place the total value of the goods of each country is still the same as before. This equilibrium position may be disturbed if the balance between social product and incomes in a country is disturbed, for then a part of the purchasing power of this country becomes available for the purchase of additional foreign goods (or, vice versa, part of the social product becomes unsalable and has to be exported). The status of the balance of trade does not turn either favorable or adverse in order to balance the disequilibrium of the other items in the balance of payments, but just the other way around: the disequilibrium orig-

inates primarily from the trade balance and all the other items of the balance of payments have to make good the discrepancy.

The currency of a country is therefore in the equilibrium position if it permits the price mechanism to balance the price sum of the social product and the purchasing power of the money incomes within the limits of the import and export points (the prices of some goods may, of course, be in an equilibrium position just at the import point, other goods just at the export point). Now this balance between social product and total income can be disturbed in four ways: first, if the income changes without a parallel change in the social product; second, if the productivity of the country changes without proportional change in the money incomes; third, if the real barter terms change without a corresponding change in the money incomes (a special case of 2); or fourth, if the import and export points are shifted through changes in the world market.

1. A change of the money incomes changes the volume of production in the same direction, that is, increasing incomes cause the social product to rise, decreasing incomes cause the social product to shrink. As the theory of the business cycle has shown, there is, however, no true parallelism. The effect of income changes upon the social product may be, depending upon the phase of the cycle, greater or smaller than the ratio of change in income, or in the marginal case, even zero. In anticipation of a later discussion it should be mentioned here that such a discrepancy between incomes and social product invariably indicates that there is no coincidence between "market interest" and "natural interest" (this holds also, of course, for the case alluded to under 2).

2. Also a change in productivity results in certain changes of income, but here the assumption of exactly proportional changes is even less warranted than in the case of primary changes in incomes. Such a parallelism would prevail if piece wages were paid in all industries. But since this is not the case, and since it is even not practicable to fix all incomes by piece wage rates, it is a priori impossible that the incomes should vary in exactly the same proportion as productivity.

3. If the exchange relation of specifically domestic products to specifically foreign products changes in disfavor of the former this implies a decrease in realized profits for the exporting enterprises, but as a loss in income it will become apparent only in the following period of production, when the enterprises will be forced to decrease costs (wages) or to restrict production or to produce subsequently for the home market. In the initial period, during which the real barter terms deteriorate, the income is still "too high," that is, after the purchase of home production there will still be a part of the income for purchasing foreign products. In passing it may be noted that also when former export industries are being transformed into domestic industries the incomes have to drop in order to restrict the balance. For when the exporting industries lose the comparative advantage they formerly had, this is an "absolute disadvantage" for the total economy, that is, the total value of the new social product will be smaller than that of the preceding social product, if measured in terms of international value. Therefore if the money incomes do not drop, all prices, including those of home products, will reach the import point; the passive status of the currency will continue.

4. Besides the three cases distinguished in the preceding paragraphs, there is a fourth way in which the currency of a country may be thrown out of balance. This is the case in which the relation between social product and income is changed abroad, though it remains stable at home. The shift of this relation in the international economy implies that prices in the world market rise or drop, so that the import and export points of the domestic market are shifted: "the country does not follow the price movements in the world market." This case is analogous to the change of the real barter terms, discussed above.

This analysis could be expanded by distinguishing a fifth case in addition to the four discussed, namely the situation in which a decrease in the international costs of transferring the goods (decrease in tariffs or abolition of exchange control) reduces the distance between the import and export points, so that a restoration

of the equilibrium level is rendered impossible within this reduced distance. This latter example transcends the former cases in so far as it belongs to the realm of deliberate economic policy. Unlike the others it signifies how a disturbed equilibrium can be readjusted through such devices as introduction of exchange control or increase in tariff. To be sure, a change in tariff policy can restore equilibrium only in the event of a minor disturbance, and therefore in the later paragraphs of this discussion I shall mention this possibility only in passing.

More important is the role played by exchange control. In this the two devices that are usually applied are a restricted apportionment of foreign exchange to the importers, and the imposition of a premium on foreign exchange; of these only the first shall be discussed here. A premium on foreign exchange is tantamount to devaluation, as will be discussed later.

Exchange control offers a way out of a passive exchange situation, because theoretically it can raise the import point indefinitely. Commodity prices may rise any distance above the former import point, for the goods under consideration are imported only in proportion to the foreign exchange allotted to the importers. Those importers who receive the exchange will earn a rent in this way, but the purchasing power of the total money incomes will shrink, because now prices are free to climb above the old import points and will indeed do so, *ceteris paribus*.

There is still another reason why a balance between incomes and social product can be obtained through exchange control. If exchange control is established to remedy the passive status of the currency situation, and if the introduction of this compulsory measure temporarily coincides with a depression, as is usually the case, there will be unemployed factors of production. As a result of the exchange control these factors of production can now be reemployed, because commodity prices will rise in proportion to the prices of the factors of production (that is, wages), so that production becomes profitable. Thus in Hungary after 1931, for example, after the introduction of exchange control, there sprang

up entirely new branches of industrial production which formerly, under conditions of free currency exchange, could not possibly have survived. The restricted apportionment had therefore an effect similar to that of a protective tariff or a currency depreciation. Thus it can be seen that the introduction of exchange control is capable of bringing about an equilibrium between social product and incomes in two ways: by an increase in the price level the purchasing power of the money income will be depressed, while at the same time the social product can be increased through an effect which may be likened to the effect of a protective tariff.

One thing has thus become obvious: if the equilibrium between the purchasing power of total income and the price sum of the social product is disturbed, there are no counter-tendencies likely to arise automatically which would operate in the direction of a restoration. A disturbed equilibrium can be rectified only through the tool of a monetary policy. This can be done in two ways: either the relation between incomes and social product can be controlled by means of a manipulation of interest rates; or the import and export points can be shifted through adjustment of the exchange rates (or through tariff policy, or exchange control, as discussed above). If neither of these political interventions is effective there will be a disproportion between the purchasing power of the money incomes and the price sum of the social product. That means that the country will be in a position to buy more or less than it produces, depending on the direction in which the disproportion points, and the difference will have to be compensated by new credit relations with the outside world (or gold movements, as discussed above).

There is nothing more to be said theoretically about currency policy. That the export point can be lowered at any time or the import point can be pushed up by a change in the exchange rates (only the latter case is of practical importance) is a truism. This method means that the import and export points have to be shifted so that the equilibrium level of prices again lies between them, for this is the only way that equilibrium may be attained.

This solution, theoretically so simple, is in practice applicable only with caution, for instability of the country's own currency has many disadvantages for the economy. The arguments pro and con are too well known to need further elaboration here.

We know too that the quantity of purchasing power in circulation can be diminished or expanded by means of an increase or decrease in the interest rate. Any change in the circulating quantity of purchasing power implies a simultaneous change of the money incomes in the same direction. Whenever a discrepancy arises between money incomes and social product, equilibrium can be restored by raising or decreasing the interest rate. But this procedure involves this difficulty: a change in the interest rate will change not only the money incomes but also the social product. Hence it is not possible to look at the problem as if the social product were given as a fixed magnitude and the regulation of interest rates could confine itself to the mere task of adjusting the money incomes to this social product. It is true, however, that the money incomes and the social product will react differently to a shift in the interest rate, and thus in theory governmental manipulation of the interest rates can always bring about equilibrium.

In this connection it should be noted that the usual argument in favor of raising the interest rate to defend the exchange rate is that domestic prices are too high. This reasoning is not defensible. Prices can show differences only to a certain degree, as explained above. If prices have reached the import point there is an inflow of commodities from abroad which can be paid for only through indebtedness. Therefore the argument in favor of increased interest rates ought to be that without this increase the exchange rate could be maintained only through contracting foreign loans. Thus it is not that prices are too high, but that the money costs of production are too high, so that in the long run production could not go on; either costs must be cut, or exchange rates increased.

The regulation of the interest rates has a second effect besides the effect discussed above: it attracts foreign credits. Hence the process is not of the simple nature that the interest rate is put

into effect merely in order to avoid indebtedness to the outside world; this may be so (if those responsible for the monetary policy succeed in preventing a rise in the costs of production at a time when prices are still below the import point and when their further rise is therefore still capable of bringing about equilibrium between social product and incomes), but it need not be so. Provided the international credit market is functioning well, any increase in the interest rate is bound to attract at least short-term funds from abroad. This contributes in no slight degree to an increased elasticity of the economic mechanism. But if no foreign credits can be obtained, even with the increased interest rates (and this is what actually happens time and again, when confidence in the international capital market is shaken), the disruption of the equilibrium has to be corrected by means of a new currency depreciation (except in the case of slight disturbances, which can be eliminated through shipments of gold abroad or through reduction of the foreign exchange reserve). In other words, the currency can be kept stable only if the managed interest rate prevents at once any tendency to disequilibrium between incomes and social product.

Needless to say, these problems emerge only from a passive exchange situation. If the exchange situation is active the equilibrium position can be restored at any time through manipulation of the interest rate (credit inflation). In the following I shall deal only with the passive exchange situation, unless I refer explicitly to the opposite case.

We are now in a position to sum up the conditions for a stable currency as follows: the purchasing power of the money incomes can deviate from the price sum of the social product only as far as foreign credits are available for balancing the difference. As it becomes impossible to obtain credits from abroad, the currency can be kept stable only by preventing at the outset a discrepancy between incomes and social product. If the monetary policy is not successful in achieving its end the stability of the currency has necessarily to be given up. Theoretically monetary policy can

always fulfil this task, but in practice it encounters difficulties of considerable magnitude. As everyone knows, monetary policy is concerned not only with currency problems, but also with problems of the cycle. The two objectives may come into conflict with each other. This holds particularly for those cases in which the discrepancy between social product and incomes is caused by sudden changes in the world market, by deterioration of the real barter terms, by technological changes abroad, by poor crops in an agricultural country, or natural catastrophes, revolutions, and the like. In such cases, where there is a sudden decrease in the social product, it is almost impossible to keep incomes and social product in balance by means of monetary policy. For the sake of both business and labor it seems expedient not to change the incomes too rapidly, especially not by monetary measures, which must be drastic if they are to bring about a rapid decrease in incomes. Therefore when there are sudden changes in the social product foreign borrowing can be desirable, in order that the monetary policy can achieve its end in a longer period, hence without any drastic operations. If foreign credits are not attainable depreciation becomes a necessity. The stability of currencies can therefore be guaranteed only when there is a well functioning credit market.

III

In view of the decisive role played by the international credit market in the stability of currencies, we must in this context examine international credits more closely. For the sake of convenience I shall distinguish in the following discussion between productive and unproductive credits. The economic significance of the distinction is that credits of the first kind have the function of improving the productivity of the debtor country, and of securing for the creditors a higher income from interest than could be had in their own country; credits of the second kind have the function of restoring temporarily the disturbed equilibrium between incomes and social product. The former follow the international differences in the natural interest rates, while the latter

are determined by the market interest rates, which deviate from the natural interest rates.

The natural interest rate can be defined (of course only in this connection; it is not necessary here to give exact definitions) as that rate of interest under which the price level remains stable; therefore under market rates differing from the natural rate the price level is bound to fall or rise. The international differences in the natural interest rates depend upon the different degrees of industrialization in the different countries. The greater the share of capital which is allotted to the other factors of production (per unit of labor and land), the smaller the natural interest rate, and vice versa. Differences in the natural interest rates can cause capital movements from the countries with lower interest rates to the countries with higher interest rates, provided that the risk factor is smaller than the difference in the interest rate.

After these preliminary remarks three characteristics of a productive loan may be distinguished. First, the incentive to such a loan does not come from the currency situation, hence neither from commodity prices nor from an unbalanced trade balance. At the start of the process, according to our assumption, the currency situation is in balance, and the loan is given only because investment of capital in the country which has the higher natural interest rate may be of advantage to both the debtor and the creditor country. The movement of commodity prices and the emergence of a passive balance of trade at the start of the process, and of an active balance at the close of the process, are therefore an effect, not the cause, of the loan. Second, the movement of commodity prices and of the trade balance remains, with regard to time and quantity, within the limits given by the scope of the loan. Third, the market rate of interest, according to our assumption, is on an equal level with the natural interest rate, at the beginning of the process. In the course of productive indebtedness, and also during the amortization period, the market and natural rates of interest follow different lines, and these deviations between interest rates cause the price movements under consideration. The

result (in the ideal case) is a decrease in the natural interest rate, and a proportional increase of incomes and social product.

With respect to this latter point it should be mentioned that restoration to equilibrium in the currency situation is not guaranteed by the fact that the market rate of interest coincides with the natural interest rate. The natural rate guarantees only the elimination of the first two of the four factors which were discussed above as disturbing the balance between social product and total income; the second two disturbing elements can become effective, however, even under a market rate of interest which is in accordance with the natural rate. According to our definition above, the natural interest rate implies a stable price level; but whether this price level is too high or too low depends upon the rate of exchange and prices abroad. If the price level is too high the interest rate has to be lifted temporarily above the natural rate, and only when the price level has decreased in due proportion can the interest rate be brought to its natural level; in other words, the relation between social product and incomes must be temporarily disturbed in order that prices will reach a level that makes an equilibrium position possible through interplay with world prices.

On the other hand, an interest rate differing from the natural rate of interest can prevail only for a short time without becoming a danger to the currency, for under such an interest rate the prices of a constantly increasing number of commodities are bound to reach either the import or the export point. Soon a discrepancy between incomes and social product is bound to arise, in which case—provided there is a stable exchange rate—the gap has to be bridged by borrowing or lending abroad. These foreign debts differ fundamentally, both in their economic significance and in their whole mechanism, from the productive loans discussed above. Hence the specific characteristics of this second kind of foreign debts should be examined separately.

The credits which we have characterized as unproductive arise out of a situation in which the currency would have to be depreciated if these credits were not given. A more clear-cut distinction

between productive and unproductive credits is difficult, because there are cases on the border line which can be attributed to both categories, and because very often the decision can be made only subsequently, on the basis of the effect the credits have brought about. According to the foregoing discussions credits should be called unproductive if they merely help to keep the domestic incomes above the level of the social product. But there are, of course, cases which could not be classified on this basis. For example, if an agrarian country borrows foreign funds on short terms, it will depend upon the degree of indebtedness whether these funds are to be considered productive or unproductive. If the indebtedness is restricted to an amount which can be met later by a seasonal increase in production (and therefore in exports), the credits should still be termed productive, since without them domestic capital funds would have to be used, and with them these domestic funds can remain invested for productive purposes. If, on the other hand, the indebtedness exceeds this measure, the credits serve to maintain an income level which is not subsequently justified by a rising social product; hence they are unproductive. It is true that also in the former case, which we called productive, the credits have the function of keeping the incomes temporarily on a level above the seasonal level of the social product. But in that case a corresponding increase in productivity can be counted on, if the seasonal fluctuation behaves normally, and therefore it would be wrong to characterize these credits as unproductive only because they are used to bridge a temporary gap between incomes and social product.

To be sure, even unproductive credits can serve only temporarily to bridge the discrepancy between incomes and social product. But what distinguishes unproductive credits is that their prime cause is not the international differences in interest rates, but the international price differences, which in turn are a consequence of the unequal development of incomes and social product. For this situation there are three possible solutions—price deflation by means of managed interest rates, currency depreciation

and foreign indebtedness; the last of the three will be resorted to if it is the course of least resistance.

In the last analysis indebtedness takes place therefore because more and more goods reach the import point in consequence of the unequal development of incomes and social product, so that the trade balance turns passive. In other words, part of the import can be paid for only through borrowing funds from abroad (or through depleting the favorable accounts with the outside world, if we are concerned with a creditor country). The process will go on as long as the basic situation persists, that is, as long as the equilibrium between incomes and social product is not restored by managed interest rates or depreciation of currency.

It might be appropriate to illustrate these discussions by some examples taken from the recent history of currencies. The British currency depreciation of 1931 and the French depreciation of 1936 were a result of too highly fixed incomes (wages). These high costs made it more and more difficult for these countries to compete in the world markets, and the crisis which thus originated in their export industries grew into a general depression so that a comparatively low social product was confronted with an income level comparatively too high.

In England the high wages ensued from the wrong stabilization of the pound sterling rate (1924). Had the pound been stabilized at a lower rate the nominally inflated wages would have lost part of their real purchasing power through an increase in prices. But this rise in prices was prevented by making the stabilization rate too high. Under this rate equilibrium could have been restored only if the incomes had been depressed in the right proportion through managed interest rates. This was not feasible, however, because of social considerations and because it would have interfered with certain strategical measures against the depression. Thus the pound always tended to weaken, since its stabilization and the country's equilibrium were maintained at the expense of Britain's accounts abroad. It was only when it became clear, in the crisis of the summer of 1931, that England could no longer

tolerate the depletion of its foreign accounts and that a wage cut under the prevailing political situation (labor government) was out of the question, that the British were ready to depreciate the pound. Of the three possible solutions for a disturbed currency balance—decreasing incomes, borrowing from abroad (or reduction in the accounts abroad), and currency depreciation—Britain chose the second possibility between 1924 and 1931, and since 1931 has followed the third possibility. The income rates have remained untouched through the whole period.

The history of the French currency in the last few years shows the same problem from another angle. Poincaré's stabilization of the franc (1926) evaluated the franc very cautiously. Therefore it fixed the exchange rate, in contrast to the then overvalued pound, comparatively low. That explains the strength of the franc's position in the following years, and even in the crisis of 1931. After the depreciation of the pound and the dollar the favorable relation of the franc to the other currencies turned into the opposite, and in France the situation became similar to that in England prior to the depreciation. Then came Blum's laws, which combined an increase in wages with a limitation of working hours. Since the "pump priming" effect of the simultaneous inflationist measures was a complete failure (not least because of the overvalued franc, which from the outset doomed the export industry to depression), the currency situation had to become still more passive, because the increased money incomes were not in line with a diminished social product. So depreciation of the franc was resorted to, at the end of September, 1936. But that could not possibly bring about the desired solution, because the effect of the price increase was offset by the simultaneous wage increase. The disproportion between incomes and social product failed to be eliminated, because every currency depreciation since 1936 has been followed by an increase in wages which restored the disequilibrium.

Thus the history of French currency depreciation could serve as an example of the theory put forward here, if the picture were

not distorted by the flight of capital. It is certain that the French currency situation is partly determined by the capital flight, but in analyzing it we can dispense with this factor because the capital flight is entirely independent of the foreign exchange market and is determined entirely by political factors. As long as political insecurity continues, the flight of capital will continue, no matter at what point the franc is fixed. Assuming, however, that the capital flight and the attendant political insecurity should cease, the franc would become stable again only if the newly stabilized exchange rate would permit a price rise which would not be annulled by a subsequent rise in wages, that is, a price rise which would allow a new equilibrium between incomes and social product.

The movement of the Dutch guilder between 1931 and 1936 is an example of how a disturbed currency equilibrium can be restored through management of the interest rate. After the depreciation of the pound in 1931 the guilder was overvalued, that is, the Dutch currency situation became passive. In the following years, however, the cautious interest and credit policy of the Dutch central bank, exerting pressure on the incomes, succeeded in restoring equilibrium between incomes and social product, even at the expense of a continued depression at home at a time when the outside world showed signs of a new recovery. Only after the depreciation of the franc did the guilder have to be devalued, because a new pressure upon the income level would have meant intolerable sacrifices. The fact that the guilder needed proportionally the slightest depreciation of all currencies shows the degree of success achieved by the efforts of the Dutch central bank in the preceding years.

IV

From these examples it can be seen that the degree of unproductive indebtedness is not rigidly limited. When the turn will occur depends largely—disregarding the particular conditions in each concrete situation—on the form in which the unproductive credits are received. The fact that unproductive credits are initiated by

commodity prices which are relatively too high does not imply, however, that these credits must take the form of commercial credit. Any foreign credit which is not used for production, and which therefore is not invested to increase the domestic social product, serves to maintain the passive situation. If it has been contracted in the form of commercial credit or of short-term bank credit the process is likely, although not sure, to reach its end soon. Least dangerous is the case when the credit is granted at the outset to support the currency, for then there are certain limits set from the very beginning. The most dangerous case, on the other hand, is when the indebtedness is presumably incurred for productive purposes, but is really used unproductively (*Kapitalfehlleitung*). Here the passive situation will persist longest, not only because the credits are on a long-term basis and are usually of large amounts, but also because, at least in the first phase, the transfer of an unproductive loan looks much like that of a productive loan. It should be emphasized once more, however, that the duration and scope of unproductive indebtedness have only secondary significance.

The longer the process lasts, the more difficult will it be to restore the equilibrium position without currency depreciation. The basic situation which constitutes the point of departure for the unproductive credits is a situation, as has been shown, in which the incomes are too high in relation to the social product, and the problem to be faced in restoring the equilibrium is how to depress the incomes or to increase the social product in due proportion. It is necessary to subtract from the social product the interest and amortization on the contracted loans as well as the debt itself, and the greater the dimensions which the indebtedness assumes, the greater the discrepancy between incomes and social product, and the more drastic the efforts which are required in order to restore equilibrium.

Now the economic significance and the importance of unproductive credits become clear. Unproductive foreign credits make for a less rigid relationship between incomes and social product.

This considerably enhances the elasticity in the economic set-up by making possible a restoration of equilibrium in the most rational way, with a minimum of friction, that is, without currency depreciation and without too drastic an application of the device of managed interest rates. In this roundabout way "unproductive credits" may still have a "productive" effect. It has been shown above that this effect is to be expected especially if the equilibrium between incomes and social product has been disturbed by sudden changes.

Take, for instance, an agrarian country in a year of extraordinarily poor crops. Without foreign credits the incomes have to be deflated in a most drastic way if currency depreciation is to be averted. It would be unnecessary, however, and also harmful for the non-agrarian production as well as for the cyclical development, to try in this way to compensate the lag in production in a single year. The foreign credits make it possible to spread the curtailment in income over a longer period, so that the economy is, at least partly, saved from the shocks of a depression. They make it possible also to restore the equilibrium between incomes and social product (though it should be remembered, of course, that during the period of amortization the rates due have to be deducted from the social product, so that the discrepancy between the two is even greater than before).

Inverting what has already been said concerning the origin of the passive exchange situation, we may state that the equilibrium between incomes and social product can be restored in three different ways: by increasing the social product; by decreasing the incomes; and by a movement of both factors in the same direction but at different speeds. Hence for an evaluation of unproductive credits the decisive question is what they can contribute toward a restoration of the equilibrium in a way which will impair the social product least.

In the above example (poor harvest) a later increase in the social product could be expected, and the credits had only the function of spreading the income deficits over as long a period as possible.

The case is similar to the one of bridging difficulties due to seasonal fluctuations. But such an automatic increase in the social product cannot be relied upon. In most cases a restoration of the equilibrium through lifting the social product is conceivable only as an exception, as in certain cyclical situations in which the social product, with the help of credit creation, can be increased faster than the money incomes (prosperity with decreasing prices).

Usually the solution lies in the direction of income reduction, but this can rarely be carried through without simultaneous, if not proportional, decrease of the social product. As has already been said, bringing down the income level by drastic manipulation of the interest rate mechanism or by currency depreciation is accompanied in either case by great damages for the economy (that is, by a decrease in the social product).

The contracting of unproductive credits will be advantageous in the following cases: first, if the "passive currency situation" is of a temporary nature and an automatic increase of the social product can be relied upon (poor harvest); second, if the passive currency situation coincides with a "favorable constellation of the business cycle"; and third, if the incomes can be depressed through managed interest rates in due proportion and if the accompanying damages are smaller than those which would accompany currency depreciation. On the other hand, the contracting of foreign credits fails to reach its purpose (and is therefore harmful) if the discrepancy between incomes and social product is not of a temporary nature, that is, if an automatic restoration of the equilibrium cannot be relied upon and at the same time the currency is in such a situation that equilibrium can be restored by means of managed interest rates only through such a drastic increase in the rates that the accompanying damages would be greater than those which would accompany depreciation. Thus the danger of unproductive foreign credits is that they may not only spread over a longer period a sudden lag in production, but may also maintain an income level which is relatively too high.

(*Budapest*)

ART AND SOCIETY

IT HAS long been realized that in art not everything is possible at any given time and that a style can assume its specific form only because of a given historical situation. It would seem self-evident that this should imply that a style is dependent also on the existence of a given social situation and that art and society stand in a continuous interrelation. But strangely enough this problem has only lately been taken up, in spite of its decisive importance. In the early nineteenth century it was considered by Balzac and Taine; but under the influence of the romantic and later the materialistic trends (according to which art was a problem of either mere genius or mere technique) it was pushed aside, and it has been revived only recently, usually in the rather emotional way of Spengler or in the rather simplified way of Sorokin.

Herbert Read, in a book based on a series of lectures which he delivered at Liverpool University in 1935-36, has made a substantial contribution to the discussion of this subject.¹ Read is deeply interested in art and the difficult situation in which it finds itself in modern society, and he has covered an extraordinarily wide field of history. His book is thought-provoking to the highest degree: it invites the reader to ponder the problems not only of the relations between art and society but of those between art and almost any possible sphere of human thought and human activity, from prehistoric religion to psychoanalysis and art education, and it attempts to elucidate the central problem from an astonishingly wide range of angles.

The single parts of the book are relatively independent of one another and thus an abbreviated account will be difficult and will occasionally, I am afraid, do injustice to some of Read's ideas. Nevertheless the whole work is based on one principal conception: art is an "autonomous activity, a mode of understanding the world," but since it is also a "quality belonging to objects which are produced to satisfy practical needs," and has "necessary relations with politics, with religion and with all other modes of reacting to our human destiny" (p. xiii), it is "woven into the social fabric." The artist "socialises his own experience; the group accepts this individual experience as a socially valid symbol" (p. xiv).

In contrast to previous opinions a particularly artistic sphere is attributed to the paleolithic as well as to the neolithic period and to the art of living primitive men. In primitive society, although art is a par-

¹ Herbert Read. *Art in Society*. New York: Macmillan. 1937. 282 pp., 100 plates. \$4.50.

ticular sphere, based on an individual gift of the artist, it also fulfils a social function through its symbolic ritualistic meaning, which obviously concerns the whole community. This collective function is fulfilled quite naturally by "special individuals, who through special faculties of sensation or special skill in expression can appeal to the mute emotions of their fellowmen" (p. 68).

But in later ages a conflict arises. In Greek, Buddhist, Semitic and mediaeval Christian society religion is differentiated from life, is no longer insolubly linked with it as in primitive society, and therefore a distinction is made between a natural and a supernatural order of existence. Art becomes an intermediary between these orders, and since its function is "to render the invisible visible it has to be controlled by those responsible for the social unit" (p. 81). While some religions (Buddhism, ancient Greek) educate the artistic impulse, others (Judaism, Islam) discount it, turning it in a decorative direction. Christianity, according to Read, has passed through different stages; at first it was inimical to art, later art was permitted, and finally during the controversy over iconoclasm in the north of Europe it became "introverted" (partly as a result of the climatic factor)—in other words, again inimical to art. "What is the Gothic cathedral . . . but the representation in stone of a vague instinct and aspiration, which we can best describe by the abstract concept of transcendentalism?" (p. 124). Protestantism, especially, has always been suspicious of the aesthetic values (p. 126). Moreover, there developed a break between the "esoteric significance [of art], only vaguely apprehended by the people, and the minor arts which were also the popular arts." The abstraction of the Gothic cathedral was "to be hung like a Christmas tree with bright statues and paintings and pictorial windows" (p. 124).

Since the Italian Renaissance art has become secularized; but the artist, instead of submitting himself to the religious belief, depends on his ability to express himself in conformity with the general social creed and the general economic situation. He has to deal on the one hand with the "complex mass which we call society or the people . . . whose demand is for realism" (p. 144), and on the other hand with "a restricted elite" (Read refers to Pareto) which establishes the taste of the period and which is identified with the governing class. The artist himself belongs to this elite, but his "genius" induces him to transcend "the limitations of the particular traditions into which he is born." He cannot simply express his individual feelings (which according to Read would be his ultimate desire); to be understood and to make a livelihood he has to use a conventional language spoken by the elite, the

language either of "classicistic idealism" or of "romantic moralism." "The work of art has become a commodity which the artist must sell . . . and the price . . . is one which only the rich can afford" (p. 171). The rich, however (since they are men of action), "are in all matters of sensibility and taste both vulgar and stupid" (p. 171). The solution of this dilemma of the artist is either revolt or escape. Hogarth, revolting against the classicist ideal of the elite, created a moralizing popular art which, however, according to Read, suffers from this conflict; the romantic painters, on the other hand, escape into a world of imagination.

Read makes an attempt to find a psychoanalytic basis for the conflict between artist and society. The artist is the individual able to penetrate instinctively his own "subconscious"; thus his ego (his artistic quality) is driven into a continuous conflict with the id (the subconscious instinct) and with his superego (which is related to society and his aspirations). This psychoanalytic interpretation (which Read parallels with Plato's conception of art) is taken as a basis for a program of art education. The aesthetic instincts "which are the normal possession of children" (p. 223) should be educated, and not alone the intellectual and moral values, and they should be made the basis of a training in art appreciation for a social group as large as possible.

Finally the author attempts to show the dualistic conflict within the art of our own age. He distinguishes three types of modern art: bourgeois academic art, revolutionary art, and functional art, wherein a balance has been found between artistic interests and the needs for which the work of art was created.

Read's basic conception, that art is a creative force in itself, is sound. Of course art is art—and not religion, magic, capitalism or anything else it may be related to. To have reestablished this fact against certain exclusively psychoanalytic or naive sociological interpretations is an important achievement. I wonder, however, whether in his attempt to rehabilitate the artistic sphere Read has not fallen into the opposite extreme. For in spite of acknowledging the influence of economic, religious and climatic factors on the realm of art, he still shows an unmistakable tendency to underrate these influences by assigning to art a definitely superior position. He not only recognizes the autonomy of art but he attributes a higher value to the artistic than to the non-artistic domains of life.

Although the artist belongs in the particularly aesthetic sphere, at the same time he participates in a number of non-artistic spheres, since besides being an artist he is a member of society and has to live

in it. Thus he is frequently forced into an oppositional attitude toward the non-artistic spheres—and it is this conflict which according to Read forms the dilemma from which the artist suffers, which marks his particular position in society and at once impoverishes and enriches him. This assumption too seems to be based on the thesis that art has a higher value than the non-artistic spheres. For the situation of standing between different spheres is one which scarcely affects the artist exclusively; it affects generally any member of any particular group in his relation to the wider community, and wherever this situation exists it will be a source of conflict. To reconcile this source of conflict with the necessity of living with and within society is the problem of every member of such a group.

In Read's interpretation art appears as diametrically opposed to any other cultural force. From the very outset—after the age of primitive art has been disposed of—Read puts art on a defensive basis, and it seems to me that this is his fundamental mistake; he interprets art as a human activity which is not only continuously persecuted by the social forces but is by its very nature rooted in this unfortunate position more deeply than other activities, religious or intellectual. Consequently the artist is regarded as a natural outsider of society who is always in disharmony with it. It would be nonsense to deny that such an opposition exists and that it is especially strong in our own period. Read's elaboration of this problem is the pivotal factor of his book and he considers it with the ardor of a lover of art who sees the object he loves in danger of being definitely shut off from the life of society.

I wonder, however, whether the isolation of art from the life of society, and thus its "dualistic" situation, has not developed only gradually in the course of history, instead of being an innate element. It seems to me that it was not until the early nineteenth century that the artist was generally considered an outsider. Only since the period of romanticism has he become in general opinion the "bohemian" (Murger), "the poor poet" (Balzac), "the wandering painter," "the good-for-nothing" (Eichendorff), one who is sometimes ridiculous, sometimes pitiful, sometimes a mere lazybones, sometimes a genius—but certainly not a useful member of society. This attitude toward the artist seems to have arisen only with the development of high capitalism. Occasionally it appears earlier. It can be found here and there from the sixteenth century on, in those countries and periods where capitalism first began to flourish—in Florence, Holland and England. One of the earliest instances I recall is Vasari's picture of the queernesses of certain artists of the fifteenth century, in which he tries to depict

them as unbalanced minds and different from "normal people"; possibly the conception of the unbalanced artist could in rare cases be traced back even to the fourteenth century. But in Vasari's account this outsider position of the artist is still limited to the individual case; it does not refer to the whole group. Only after the first third of the nineteenth century did the conception of the artist as an outsider by nature become definitely established. This conception is connected with the fact that in the growth of capitalist society the artist is bound to lose eventually the established function which he occupied in pre-capitalist and even in the early capitalist society of the fifteenth, sixteenth and seventeenth centuries.

In high capitalist society the artist is an independent contractor who sells his products to an extremely small group of buyers, and these buy his products as a mere luxury without really needing them, as Read formulates it. But I think that the differences between earlier and later stages of capitalism and the differences between the position of capitalism in different countries ought to be taken into account. As long as art advances the prestige of the buyer, as long as it strengthens his position against other social strata, such as the nobility or the church, as long as he has to take over functions which had previously been fulfilled by other layers of society, the capitalist very definitely needs art and also needs the artist. This is the situation which was dominant, for example, in Florentine capitalism of the fifteenth century and which still dominated wide bourgeois circles in the nineteenth century. In these circumstances art and the artist are certainly admitted within capitalist society.

It seems to me that Read lays too much stress on the reluctance of capitalist society to admit the artist and on its belief that the artist should comply with its ideals and adapt his work to its taste, an adaptation which Read contends is bound to create a mute opposition that reveals itself in the artist's work. I should be inclined to emphasize more the different degrees to which the artist is admitted into capitalist society in its different stages and under different conditions, and to ask why the outsider situation of the artist does not exist within pre-capitalist mediaeval society. There the church, the court, the nobility, being public institutions and therefore constantly within the public eye, had to insist on a continuous confirmation of their social position and also of the ideas for which they stood and of which they were only the secular representatives. The ideas on which mediaeval society was based were not "useful" values, in the modern sense of the word, and thus art, which itself does not belong in the category of useful values, had

there a recognized function. The conception that the artist is necessarily an outsider could not take form before the useful had been made the regulating principle of society.¹

I suppose Read would agree with these objections, but he would say that the situation which presents itself in mediaeval society is merely less overt than the one which developed later in capitalist society. Even before capitalism the artist depended on those "responsible for the social order" and had to make continuous concessions to the ruling classes so as not to lose his livelihood; and these concessions lessened the quality of his work. I think we can agree that the concessions were made. But are concessions which are made without strain still concessions? Before the sixteenth century, and in most cases up to the nineteenth century, the artist's image of the world fitted the general image held by the rest of society. Contrary to his attitude in the modern world, in previous periods his conformance with society and its ideologies was usually without any strain or mute opposition. It was not merely a mask with which the artist disguised his personal feelings in order to put them over on society; his personal artistic problems and the current ideologies formed an insoluble unit. Ideologies in which one believes have the force of realities. When Poussin created his mythologies he worked within a "communal emotional unity." This participation in a communal unity was true of Rubens, Van Dyck, Bernini, Donatello, Raphael, and almost any other artist before the nineteenth century—except Rembrandt, whom Read cites in support of his general thesis. But Rembrandt lived in Holland in the seventeenth century, within a capitalist society—and he was one of the rare precursors of the outsider position of the artist. Exceptions can never be a starting point; and historically speaking, the harmony of art and society is as much a possibility as their opposition. The one dominates in a world with a fundamentally anti-utilitarian philosophy, the other in a world in which this philosophy has disappeared. It is a historical question and a question of the given social circumstances whether harmony or opposition will prevail—not a question of the nature of art.

This question of the exceptions, however, leads to another extremely interesting issue pointed out by Read: normally the artist (whether in harmony with society or not) will be "ahead of his time," that is, he will be more modern than the taste of the general public which has been formed by older and already obsolete traditions. In these circumstances the artist—and this is one of the most stimulating points in Read's book—needs an elite which understands his art better than does

¹ I am indebted to Professor Hans Speier for a discussion of this point.

the general public. As to this elite's attitude toward art Read's position is not quite clear; on page 144 *et seq.* the elite is held to be identical with the governing class, while on page 171 the governing class is marked as "vulgar" and as forcing the artist to compromise by creating an "idealistic" art. It would seem that Read does not distinguish between a governing class and an art-appreciating elite, but an identification of the two seems to me inadmissible. The art-appreciating elite may include members of the governing class, but it cannot be identified with it, at least not in the capitalist era; it frequently includes former members of the governing class as well as members or former members of other classes, but it does not belong to any class. It is a group of "independents," what one would call a group of socially detached intellectuals. Since the art of any given period is necessarily opposed to tradition it has to rely on a group which combines persons of some means and persons of a liberal intellectual attitude; in the Middle Ages such a group may have existed within the governing class but in capitalist society it exists always at the edge of society.

Numerous instances might be mentioned throughout the history of art from the fifteenth century on. Every young artist is first supported by persons who are not responsible for the social order, and later the representatives of the governing class follow along; young art is constantly being tried out by "independents." Apparently wherever the artist is an outsider it is this same group of independent intellectuals that supports him. Read mentions the instance of Daumier, whose criticism of the ruling bourgeois society was appreciated by socially detached intellectuals in political opposition. The same holds true of Rembrandt. It is very interesting to look through the portraits he was commissioned to paint after he had become an outcast of society and his art had left the general track of the Dutch art of the period: Dr. Six, the poet, scholar and friend of Spinoza, Dr. Bueno, the Jewish physician, the art dealers de Jongher and Franckens, the painters Coppenol and De Lairese, the physician Dr. Tholinx, the poet de Decker, the scholar van der Linden, philosophers, scholars—these are mainly the portraits of this period, all of them portraits of intellectuals. It is an elite, but not identical with the governing class—an elite of outsiders. Likewise the revolutionary Caravaggio and his very independent maecenas, Giustiniani, might be cited.

But again, it seems that this formation of an intellectual elite which is different from the governing class is limited to the post-mediaeval period and is connected with the rise of the bourgeoisie. The existence of such an independent elite is determined not by the nature of art it-

self but by the historical situation, and especially by the extent to which the anti-utilitarian philosophy of the Middle Ages still survives. One may go even farther: not only does the intellectual elite become distinct from the governing class but distinctions of taste develop throughout society. In seventeenth century Dutch society the intellectual elite appreciated the outsider art of the later Rembrandt, and the wealthy bourgeois class the more conservative but very refined art of Terborch and Vlinck; the middle class was interested in the more popular and still more conservative paintings of Steen and Metsu, and the peasant class preferred a folklore art quite independent of that of any higher strata of society, as can be seen in any Dutch peasant house of the period.

Here another problem arises: the problem of popular art. Read's interesting contention is that by its very nature popular art is realistic, that it is narrative and concerned with story telling, while the essential thing in art, the self-expression of the artist, can be understood only by the elite; and often even the elite can understand it only because the artist has compromised by covering the essentials in some idealistic (or moralistic) mask which tells a story. Here too I think that Read is too much persuaded by the facts of contemporary art. Before the impressionistic period, that is, before 1860, story telling was never a compromise; on the contrary, it was the only conceivable way of expressing oneself, and the story was to the artist as important as the form which he chose for his story. Indeed, Read's contention is based on the opposition of form and content, which is of very recent origin. To think in abstract forms or to enjoy them is—perhaps with the exception of primitive art—an entirely modern attitude. Before the middle of the nineteenth century the work of art was a unit in which form, story, meaning (ideology), skill and material formed a single whole. (Historically, this unity has passed through two different phases: after the sixteenth century the existence of different parts of the whole was at least theoretically recognized—although not separately enjoyed—but before that time not even a theoretical division was possible; only a few of the parts were recognized—story, skill and material.) Thus it seems hardly possible to say that popular art has always been narrative; the art of the elite can be narrative too, and popular art is very often unrealistic.

The precious manuscripts of the tenth and eleventh centuries, painted for the Ottonian or Byzantine courts, were certainly intended for the peak of the social as well as of the cultural pyramid. This social stratum was extremely thin and was far removed from any contact

with the masses and with their popular art. Nevertheless the manuscripts painted for this small group are full of pictures which are very vivid and realistic (in a mediaeval sense), which represent a definite Christian ideology and which are arranged in refined compositions and painted in precious colors with the greatest skill. This indicates first that in the Middle Ages the differentiation between the intellectual elite and the governing class had not yet taken place, that what would later be a socially detached elite still formed a group within the governing class. And it indicates also that this selected upper stratum of society very definitely liked narrative art. As a matter of fact the identity of material, skill, ideology, form and narrative elements was one of the essentials of mediaeval art. It was not that the "mere abstraction of the Gothic cathedral" was "hung like a Christmas tree with bright statues and paintings and pictorial windows" in order to impress the masses; only with the statues, stained glass windows, altars and other "decorative" elements was the cathedral really complete—and especially in the eyes of the literate, who were the only ones able to interpret the complicated iconography of such a story and its narrative and theological implications. The same holds true of the secular art of the Middle Ages—for of course a secular art existed, in calendars, tapestries, civic buildings and the like. This art too was full of narrative elements showing the occupations of civic or country life (Siena, Palazzo Pubblico), heroic stories (Trojan wars, legend of King Artus), historic events (tapestry of Bayeux), love scenes, hunting scenes—all executed in very expensive materials for the castles and town halls of an upper class. In other words, both the religious and the secular art of the upper strata of mediaeval society were concerned with subject matter.

On the other hand the popular art of the Middle Ages was quite different: it stressed either mere ornament (the English crosses) or the ideological content of the representation. In the small village churches of central Europe there was none of the narrative content which characterized the great cathedrals; in a small village church one or two main figures might carry the whole ideology of the Last Judgment without all the numerous narrative flourishes which the literate groups demanded.

It may be, however, that Read has in mind the fact that during the late Middle Ages (between the twelfth and the fifteenth centuries) there arose from the masses a new social stratum and that simultaneously the narrative elements in art were strengthened and gradually transformed into realism. This new stratum was the bourgeoisie, and

the question may be legitimate whether its realistic interest was not connected with the fact that it arose from the masses. But from the masses of the Middle Ages the bourgeoisie could have inherited no realistic tendencies. If there existed any kind of "realism" in the Middle Ages it was to be found in the art of the upper strata, and as a matter of fact it was from that art that the narrative (and "realistic") element was taken over by the new bourgeois class and subsequently developed for the use of a broader public, partly through different kinds of substitute techniques (engraving, woodcutting, terra cotta), which arose at the same time (about 1400) and which in the beginning imitated more expensive materials.

Thus the new emphasis on realistic elements can hardly be explained by the fact that the new class rose from the masses. It can be explained only by the fact that the new class which supported the new art was bourgeois and (potentially) capitalist; apparently bourgeoisie, capitalism and a sense for realism are closely connected.¹ These three elements appeared and developed side by side. About 1400 the chief domains of realism were Flanders, northern France, Florence and Prague, which were at the same time the main centers of bourgeois influence and of a rising capitalism (Prague was the residence of the first bourgeois emperor, Charles IV). Moreover, when the bourgeoisie's original connection with the masses had completely disappeared and it had become the governing class (in Holland, for instance), the realistic interest remained essential in its art; this interest merely shifted (perhaps in accordance with the more settled situation of the bourgeoisie) from a merely representative and narrative to a more psychological and existential realism. On the other hand, in Italy and southern Germany, where after the counter-Reformation the landowning aristocracy had either seized or maintained power, both the ideological and the narrative elements of the Middle Ages were much better preserved.

I wonder whether this contrast between a bourgeois, mercantile, Protestant, anti-baroque, realistic art, and an aristocratic, feudal, landowning, Catholic, ideological art might not help to clarify the complicated interrelations between art and society and also the contrast between popular and higher art. At least the problem might justify a more specialized investigation.

¹ A. von Martin, *Soziologie der Renaissance* (Stuttgart 1932).

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BOOK REVIEWS

ADLER, MORTIMER. *Art and Prudence*. [A study in practical philosophy.] New York: Longmans, Green. 1937. 686 pp. \$5.50.

Dr. Adler likes to produce a surrealistic effect, so to speak, by causing a short circuit across history and throwing light on modern phenomena from surprisingly old vantage points. What would Plato or Aristotle or Thomas have said about Hollywood? Through almost seven hundred pages in his recent book on the movies Adler holds himself to be only the mouthpiece of the ancients.

Obviously such a method involves a definite philosophy of history. What does Adler's picture of history look like?

To a certain degree it resembles that of Spengler. It is the negative of the picture of history which the nineteenth century set up under the category of "progress." Adler's *Leitmotiv* could be called "regression," although this term does not appear in his book. This concept of regression has been prepared by Christian theology, first by its theory of the "fall of man," second by its theory of revelation, for revelation makes mankind after Christ incapable of finding new essential truths, since it is no longer in need of truth. It is obviously not accidental that Adler's theory of regression appears to be closely connected with Christian theology.

Adler's thesis runs as follows. Up to the time of Thomas there took place a sort of *true* history during which mankind had the chance to discover truths once and for all. What follows is merely "commentary" (p. ix). The world of our objects may have changed — no remnants of movies in Athens are known to archaeology — but the principles of their interpretation were conceived in the past; we have merely forgotten them. "Everything that can be said clearly about motion pictures was said and well said long before motion pictures existed" (p. viii).

Thus, in Adler's opinion, history is in the first place a story of losses, a story of man forgetting his own essential discoveries. If this regression, this "fall of man," is to be stopped, if an adequate interpretation of the present world and of any possible world to come, is to be found, we have to step forward into the past. This "forward into the past" could be the motto of Adler's book, for it strangely combines conservatism with a progressive gesture.

The way Adler makes use of classical tradition is not traditional. He adopts not only a system of categories but a definite attitude. While presenting himself as moralist he attempts to reanimate the ancient

concept of *phronesis*; his ultimate goal is not knowledge but "prudence," "wisdom" and the practical application of knowledge for the salvation of the soul. By adopting this attitude (which in itself is a well understandable and justified reaction to the inevitable aimlessness of present-day specialized science) Adler seems to meet a general modern need.

In his book he develops this attitude of the "wise and prudent man" with regard to art. He looks at art from a moral angle, purposely ignoring its character of autonomy (of which, however, he approves in his last chapter on aesthetics). This attitude, too, looks progressive, since art today has become programmatically a political phenomenon and its title to autonomy has been contested. This is one of the reasons why his book, like certain reactionary anti-art theories of other countries (such as Unger's *Gegen die Dichtung* and Maritain's works), meets with the approval of even progressive circles. Therefore it seems all the more necessary to show that Adler's attitude only seems progressive.

Adler does not ask with what positive aim art (or movies) should be made, or what kind of ideal circumstances should be produced, or what kind of "good" man could be educated by means of the movies, or how it would be possible to make good movies; he asks only whether the "essentia" or the "natura" of the movies as they are (that is, Hollywood) produces "bad influences." Also from the sociological and the historical points of view his dissolution of aesthetic autonomy needs to be supplemented. He might have shown very instructively that the philosophical declaration of art's autonomy (for instance by Kant) can be deducted to a high degree from the isolation of the artist in bourgeois society, and that the extra-moral claim of art is no more than the positive formula of its social insularity. It would have been easy to add that this special situation of the artist ended with the rise of the movies, since the movie industry does not know isolated artists.

But Adler has not intended to formulate positive practical aims or to elaborate a sociological theory of the reasons why art and society are united or disunited; what he has aimed at is solely to endow theory with the function of supervising art. No historian will deny that Adler can find a certain synthesis of theory and practice in the philosophy of the Greeks and of Thomas. But Adler has taken from Thomas the special moral ideal which he finds in his *Summa* instead of adopting the more general task of combining theory and practice. And in his hands this moral ideal of the "spiritual" man shrinks to the ideal of prudery; in fact *Art and Prudery* would have been a more

adequate title for his book than *Art and Prudence*. The problem he so elaborately presents is simply whether the movies promote crime by sexual excitement or in some other way. In raising this problem he consumes 116 pages, in which he scarcely mentions the movies, in a vast instrumentarium of definitions of everyday concepts, a historical treatise on such men as Plato, Aristotle, Thomas, Bossuet.

Adler does not stand for the complete Platonic suppression of art. Following Aristotle and Thomas he votes for a compromise which would take account of man's undeniable corruption and of his need for relaxation. Amusement is not necessarily immoral. Not everything, he argues with Thomas, that is conveyed through the senses must be "sensual" (p. 80). "Seeing" is itself a "force of knowledge," the first step away from the "lust of the flesh" (p. 83). If the sexual excitement is less than the purification produced by the picture, everything is all right. Thus Adler's suggestions for the producers could be summarized as follows: "What you ought to produce is a commodity for relaxation. Its level, its effect on the education or transformation of man, is not of first importance. But in a certain way you have to be careful: excitement is not forbidden, but it must be somewhat less than the effect of purification." The fact that this suggestion comes from academic heights must seem to the producers a gift from heaven. They will be the more inclined to follow it since in order to do so they need only remain as they are.

On the road to this result Adler abandons the classics. He examines with really admirable completeness all the expert sociological reports which corroborate or deny the thesis that the movies exert a bad moral influence. In this he definitely proves, in my opinion, that it is impossible to find out whether and to what extent a moral damage has been produced by one or another institution. Unfortunately the style of this demonstration is esoteric; it will not be too easy to make it usable for normal sociological analysis.

Be this as it may, after having examined the whole material Adler concludes, "The position of the prudent man remains unchanged" (pp. 296 ff.). This means for Adler that the movies can remain as they are. But this conclusion is scarcely adequate. Although it may be impossible to determine whether and how detrimental the movies are, the problem of movies and morality continues. There is for instance the possibility that certain movies (setting aside their effects) are *symptoms* of morally deplorable situations. Adler has not even mentioned this possibility. Nor does he consider the fundamental fact that daily attendance at movies causes a general "subalternization" and

"infantilization" of man, at least that it prevents a possible education of taste. These facts are incomparably more important than the question of whether or not a theft in Denver or a murder in Seattle has been inspired by a moving picture. The concept of *niveau humain*, however, cannot be found in Adler's book. "Badness" means to him stealing and licentiousness, and "virtue" no more than the negation of these negations.

As to the last chapter, which deals with the aesthetics of the movies, it seems to be the most questionable one, for never are the Aristotelian categories so inadequate as when applied to the movies as works of art. Movie art is *mimesis*, imitation, Adler argues, because it is "made by man." This concept of "imitation" obviously originates in the theological principle according to which man as *creatura* is a priori unable to create. As long as the category of "imitation" is applied in this merely theological manner it says nothing specific about the movies. If it is applied in a more concrete way, however, it does not hold good for the movies. For example, the scenario writer tries to formulate his "description" of a wealthy milieu so as to meet the opinion which he believes the producer has about the movie goer's picture of a wealthy milieu. Instead of speaking of "imitation" it would be better to speak of the creation of a complex ideology or "ideogram," opaque and uncontrollable. Adler omits this sort of analysis. Art, he argues, is not obliged to be true to life (p. 208). Needless to say, with this argument he runs the risk of excusing social lies by calling them "art."

Sometimes the producer may really know the way the man of the street imagines a wealthy milieu to be. After all, the producer through his former pictures has "produced" this image. Sometimes the man of the street may even have a correct image of a "wealthy milieu." In this case his knowledge may result from the paradoxical fact that the "world" of today is to a high degree an imitation of the movies. A Hollywood picture presenting "society life" may be true to life because it presents a milieu which (in types of faces and expressions, kind of love making, disposition of leisure time and the like) has to a large extent been shaped by the movies.

Similar difficulties arise in applying to the movies other Aristotelian categories such as "unity of time and space." Nothing seems so characteristic of the movies as their capacity to present simultaneities (of different geographical places) and to make man the universal witness. Newsreels may become more important for the evolution of the movies than the usual "canned plays." Unfortunately Adler avoids discussing

newsreels, since they are "merely educational" and, as he claims, have nothing to do with movies as "art." The so-called "unity of action," too, may well be unimportant in the movies. Action as "unity" is necessary in the narrow world of the stage, but not in the open world of the movies, in which very frequently starting actions become lost like waves in the ocean of events. The screen is a window facing the world rather than a stage, isolated from the world; therefore it is highly questionable whether the specific "distance categories" by means of which art was defined in classical aesthetics can hold true for the movies.

These objections, however, go beyond Adler's book, since the only thing that matters to him in his aesthetic chapter is to classify the movies according to *genus proximum* and *differentia specifica* (p. 486). Classifying something means considering it as unchangeable. There is no other way to find the "eternal nature" or "essence" of the movies than by "apriorizing" them as they are today. This is exactly what Adler does. The further evolution of the movies will ignore his definitions. Hegel's "Was ist, ist vernünftig" did not even hold true for the Prussian state.

GUENTHER STERN

New York City

FROST, S. E., JR. *Is American Radio Democratic?* Chicago: University of Chicago Press. 1937. 234 pp. \$2.50.

The sudden rise of interest in the study of public opinion and propaganda can be attributed to three main causes: the extraordinary development of new means of communication; the general process of democratization, making mass opinion the final determinant of political and economic action; and the rise of post-democratic dictatorships which seize the monopoly of all instrumentalities of communication. It is a crucial point for the survival of democracies whether they will succeed in using these new agencies to prepare a mass democracy for the responsible task of deciding political issues in a period of great economic upheavals, social changes and the breakdown of political institutions. This question is the central topic of Frost's study. He examines the possibilities and shortcomings of the radio in modern American democratic society, thus reviewing one of the least discussed and most powerful agencies of social interaction.

The author starts out with a definition of the "democratic way of life" which should guarantee to everyone wide, varied and rich con-

tacts with his environment, creating an attitude of openmindedness and increased flexibility in thought and action. Does the American radio meet these criteria? Frost's brief history of federal regulation and his sketch of the problems of the station owner, the advertiser, the educator and the public show conclusively that the democratic intentions of the American broadcasting system are handicapped by its commercial foundations. "Private profit, censorship for commercial ends, a dictatorial selection of program material, make inevitable the subordination of public welfare to private or corporate gain and a resultant warping of the individual both in thinking and in action." Even the guiding principles basic to the present administration of radio reveal two conflicting ideas. On the one hand "radio must be free of monopoly, free in speech and free in program"; on the other hand "it must serve the interests and welfare of the people," however vague this term may be. If the philosophy of democracy is based upon the premise that progress comes through diversity and free trade in ideas, then the channels through the air have to be kept open to free transmission of all ideas. Here is the dilemma of any censorship and control.

In an attempt to outline a constructive plan toward a more democratic broadcasting system the author presents an instructive description of broadcasting abroad, confronts it with the trends of American radio and tries to picture the ideal American system which would avoid the dictatorial, nationalist control characteristic of the foreign systems and the commercial pitfalls of the present American radio. As the "American way out" he proposes the control of radio by "a federal commission freed from the undue pressure of particular interested groups and at the same time sensitive to the will of the people." Such a plan—only vaguely sketched and undoubtedly the least satisfactory part of the book—the author himself admits is far from any possible realization in the present economic and political scene of the United States. More valuable are the few concrete suggestions which Frost makes for a revision of existing radio legislation (pp. 206-09).

The real importance of this book lies less in its constructive suggestions, however, than in its clear presentation of the issue at stake and its collection and shifting of significant material. The author touches upon most of the vital questions inherent in radio development and connects them with the wider problems of modern mass democracy. The extraordinary importance of advertising in broadcasting, and hence the limitations of radio in regard to educational policies, are rightly stressed. It would have been illuminating if Frost had drawn

comparisons between radio and other great agencies of public opinion and had gone into the specific techniques of radio mass appeal. The particular implications of radio and education are taken up in an instructive last chapter on "Radio on the Campus." It is based upon Frost's more elaborate book on *Education's Own Stations*, and describes the development and necessary difficulties of educational stations. In spite of their dissillusioning experiences Frost sees important fields in which they and they alone can function. Their mission is to "serve the minority groups often neglected by commercial stations because of their interest in making a mass appeal," to function as experimental centers, especially in the field of teaching via radio, and—by building an "adequate self-directive intelligence"—to promote a democratic way of life in America. One would have liked to find in this connection some comment on the contributions of major broadcasting networks to educational programs. Their remarkable success in numerous series could bring forward methods of educational broadcasting which are able to preserve the essential listening appeal. On the whole, the most pressing problems of adult education are scarcely mentioned. Also a more detailed investigation of the relation between radio and leisure time in determining social patterns would have opened up interesting channels of discussion.

Throughout his study Frost shows that "the American system of radio makes room both for the autocratic station owner, the propagandist and the most democratic type of transmitter operation." But he questions: "Can a democracy safely delegate even a portion of so important an area as the radio spectrum to individuals who use it undemocratically?" This, in a much wider reference, is the life-and-death question of all democratic institutions. There is the momentous warning of irresponsible political parties which abuse the democratic machinery and destroy the very existence of a democratic society. The functions of the existing Federal Communications Commission, and the responsibilities that would be placed in the hands of the more powerful committee proposed by the author, should be discussed in the light of such experiences.

To have raised many of these vital questions is the chief value of Frost's study. Its weaknesses are partly due to the experimental stage in which the radio still works, making it difficult to reach definite conclusions. But the book is a first attack on the problem and should provide an important stimulus to further investigations.

SIGMUND NEUMANN

Wesleyan University

CHASE, STUART. *The Tyranny of Words*. New York: Harcourt, Brace. 1938. 396 pp. \$2.50.

Today, in the heyday of slogans, there may be something like the first dawn of a collective distrust of words. There is a favorable opportunity today for vague writing directed against the vagueness of words and for popularizing the criticism of language. Stuart Chase has sensed this opportunity. Under the peals of applause of many a molder of public opinion he has made the criticism of language itself a slogan. He has "read a few books" (p. v) —books written by Korzybsky, Ogden, Richards, Bridgman—and since he is of those who write books when they read he has made *The Tyranny of Words* out of his reading, which has been both delayed and incomplete. The reading gave him a shock, for previously, as he confesses, he trusted language completely. Now from these authors (whom, as he admits, he does not understand completely) he has learned the following: most words are bare nonsense; they could be substituted just as well by the syllable "blab"; only a few words can be verified by "referents"; this small number of words does not play any important role in philosophy; the philosophers have not been humble before *facts*; in making use of such words as "over-soul" and "idealism" they have not noticed the harm they have wrought.

One may well ask, who is meant? After all, there is a tradition of empiricism. Moreover, there is no philosopher who has not thoroughly examined the meaning of the concept "fact," which to Chase seems so clear. To the question, who is meant, he regularly answers, "our ancestors" or "the philosophers," by whom he means at one time the earliest magicians, another time Bergson, a third time "the Greeks." These "boys do not seem to be making much progress" (p. 241), and therefore it is necessary to "move the warfare from the skirmish line to the pitched battle" (p. 207).

The whole history of European philosophy and science from the sophists on can easily be interpreted as a history of criticism of ideas and language. It should not be necessary to mention the struggle against the *doxa*; the discovery of the senses as "bad witnesses"; Aristotle's fight against the lack of inductive method in Plato; the so-called nominalism discussion; Hume's attack on the idea of causality; Kant's criticism of the "pretension of ideas"; Hegel's historicization of categories; Marx's theory that words are factors of interest; Bergson's struggle against the unjustified application of space terms to other fields—to say nothing of the critical achievements of modern science from

Bacon onward. This is the story of those "boys." Chase keeps his distance from them.

Chase enters the province of language as if it were a warehouse of words founded yesterday. He does not consider that if a word is inadequate this may be an indication of its anachronism or of its once having been meaningful. Vaguely calling for clarity, he blames words because they are not the things themselves (p. 80) or because they do not resemble the nervous system (p. 81). He rebukes the philosophers for their application of deductive methods instead of inductive ones, for their believing that there exist real qualities such as "cold" and "warm"; he disapproves of logic, which makes use of substantives instead of "structures." The first reproaches disclose a philosophical primitivism not worth discussing; as to "cold" and "warm," the distinction between "primary" and "secondary" qualities has been made by one of his "ancestors"; as to the term "structure," of which he seems very fond, it represents one of the oldest philosophical metaphors borrowed from architecture—one which deserves to be thrown out of philosophy. Finally as to his theory of generalization: "Our ancestors called an animal 'cow.' They saw another animal of similar shape and said 'This is another one of the same animal; both are cows' . . . they forgot the uniqueness of every object"—to which it can only be said that examination of the relation which exists between particulars and species has never been interrupted since the Platonic "theory of imitation."

It is not difficult to be a discoverer when one lacks knowledge, but Chase's method of discovery is harmful. He flatters those who know no more than he does; he promotes the arrogance of the philistines and commends them for not understanding the great men, admitting boastingly that he does not understand them either. "Intuition may be described as turning blab and blab into blab directly known by blabbing it from mere matter into a blab blab of blab" (p. 221). This, according to him, is the true meaning of a certain phrase of Bergson—of the same Bergson who carried on a struggle against inadequate categories in an incomparably more competent way than Chase does. Since Chase's ultimate goal, however, is not knowledge but anti-intellectualism, he continues that what we are longing for is not words: "No one wants socialization as such—one cannot eat a word. One wants for himself and his fellows a good job, good food, a good house to live in, a car, a chance to send the children to high school or college." What we must understand by the term "good," and by what "verbal" theories the "good" situation can be achieved, he does not consider. Unfor-

Unfortunately most of his readers will not notice that it is he who seduces them with tyrannical words.

Chase's lack of respect, which he discloses by translating twenty-two quotations torn out of their contexts in his "blab-blabb" language, is not diminished by the fact that the first quotation which he blabifies is one which he wrote himself before his discoveries. This ostentatious self-criticism is nothing but a display of vanity by negative means.

GUENTHER STERN

New York City

PIERSON, GEORGE WILSON. *Tocqueville and Beaumont in America*. New York: Oxford University Press. 1938. 852 pp. \$7.50.

It is necessary to remember the efforts which have been devoted to the interpretation of Tocqueville's work in order to appreciate fully this excellent book. Even now there is a considerable lag between Tocqueville's fame and the scientific efforts which have been devoted to him and his work. Either despite or because of the growing decay of liberalism all over the world there has developed a modest Tocqueville renaissance that became evident at the centenary of the publication of *Democracy in America* in France and in the United States. A few French books and one German thesis present some new material, but because of their biased political approaches, either in favor of or in opposition to the author's theories, they contribute little to our understanding. Redier's very suggestive study, for example, is prevented by his royalist prejudices from being a fully valid and complete interpretation.

Pierson's book marks the first notable advance in the scientific interpretation of Tocqueville's work. By his many years of able and thorough investigation and his scientific analysis of the conditions leading up to Tocqueville's famous book Pierson has made a distinct contribution to our knowledge of the man, his thought and his historical position. In spite of its 852 pages the book reads like good fiction, and it is equally significant for the Tocqueville expert and for the historian of American civilization. Pierson has done an irreproachable piece of research work in the archives of the Tocqueville and Beaumont families, in the documents of French ministries and in the famous Tocqueville collection of Yale library. He has made use of hitherto unknown material from Tocqueville's and Beaumont's diaries and notebooks, and of many letters that were never published before. The organization and analysis of this tremendous material deserve the highest praise.

Pierson, supported by the help of many Americans, has thus been able to reconstruct the history of the American trip made by these young French visitors from April 1831 to February 1832. For the first time we learn of the background of the book in every detail. We hear of the sources of Tocqueville's information, the leaders of public, intellectual and ecclesiastical life with whom he talked and who influenced his opinions on American democracy. Throughout his preparatory notes for the future book he attempts to examine the practical working of democratic ideas and to determine the factors which make possible their success or their failure. Frequently these first notes, remarks and observations are more concise and concrete than his later philosophical and sociological generalizations. After having analyzed the positive and negative elements in the functioning of the democratic institutions he expresses, in spite of many misgivings, words of praise for democracy which do not recur in the book. He sees the individual character of the American environment, the heritage of English law, Protestantism and the will to pragmatic enlightenment as forces bringing about and sustaining the success of democracy. His recurring observations on the blessings of decentralization, local self-government and the federal principle are very illuminating. "There is one great cause, which dominates all the others and which after the rest have all been weighed, tips the balance by itself. The American people, taken by and large, is not only the most enlightened in the world but . . . it is the people whose practical political education is the most advanced. It is from this truth, in which I believe firmly, that arises in me the only hope for the future happiness of Europe" (p. 659).

Pierson's book, simply by its rigid and scientific methods, is a symbol of the converging trends in American scholarship: the enlightened tradition of democratic political philosophy in America and its consciousness of the interdependence of American and European democracies. A second, equally important quality of the book is its contribution to the social and cultural history of the frontier and to the discussion of Turner's theory. The greatest part of the book gives a detailed history of the trip, revealing the various stages of social development in New York, New England, the frontier region and the south. The detailed presentation of the interrelationship of patterns of social conduct, of the spirit of the ruling classes and of political institutions is an important sociological contribution to the history of American civilization. In the last chapters the author has formulated, with admirable balance and scientific accuracy, his conclusions regarding the defects and the enduring elements of Tocqueville's work, and

has pointed to the peculiar significance of Tocqueville's character and thought in the contemporary world.

The publisher has presented this book in a most attractive form by adding a score of Beaumont's American sketches which were never published before.

ALBERT SALOMON

WEINREICH, MARCEL. *Max Weber, l'homme et le savant*. Paris: Librairie J. Vrin. 1938. 212 pp. 30 fr.

The formulation of the title indicates the author's purpose. He aims at an interpretation of the life and work of a man of genius who represented the end of an epoch. Weinreich has devoted a considerable part of his book to a study of Weber's life and his heroic efforts to realize freedom in an epoch when life was becoming increasingly institutionalized and mechanized. He has brought out very well Weber's consciousness of the growing rationalization of our culture, and has revealed how this consciousness formed the background of his scientific work and marked the limitations of its content. Without any explicit statement Weinreich shows that Weber's antimetaphysical attitude was no less dogmatic than that of Hegel or Marx. In this biographical discussion Weinreich has, however, omitted one very important point—Weber's participation in and contribution to the preparation of the Constitution of Weimar.

The second part of the book analyzes the unity of Weber's theoretical and practical work. The author develops the epistemological ideas of Weber as opposed to the application of naturalistic methods in the social sciences and also to the spiritual and idealistic traditions of German philosophy. He introduces this chapter with an analysis of Rickert's work which shows in what points Weber has transformed the latter's position. Weber's theories of understanding, causality and ideal types are presented well, though perhaps too compactly. In analyzing the different types of causation Weinreich makes some illuminating remarks on the danger of conceiving chance and objective possibility in terms of causation. He points out that in applying his methodological principles to sociological research Weber departs from strictly causal explanations, and that in his studies on Puritanism and capitalism he resorts to an "a-causal interpretation." Weinreich emphasizes the categories of combat and competition as fundamental to Weber's theory of social action, and contends that the chapter on the types of domination is the center of the sociological studies.

Especially in analyzing the studies on the sociology of religion Weinreich points out the various principles by means of which Weber attempted to understand the individual character of European civilization and its particular type of rationalism. He makes it clear that Weber's sociology is an instrument rather than an end in itself, and that it is intended as a means of understanding the historical process. He points out, however, that the complications of Weber's methodology might have been avoided by a philosophical approach that did not exclude a phenomenological method. For this reason he describes Weber's work as a tragic unfinished achievement that had to remain fragmentary in spite of his encyclopaedic knowledge. For the most part, however, Weinreich presents an interpretation of Weber's thought without making any attempt to enter into an extensive discussion of its implications.

Although Weber is well known among French students of sociology and philosophy (there are excellent chapters on him in R. Aron's *La sociologie Allemande contemporaine* and *Essai sur la théorie de l'histoire dans l'Allemagne contemporaine*) Weinreich's work marks the first time in France that an entire book has been devoted to him. There was a need for such a book, for the biography by Marianne Weber is available only in German and is a voluminous work. Weinreich has provided a very good introduction to the student who wishes to become acquainted with the thought of a man who finished the epoch that began with the clarity of Descartes' rationalism.

The very rich bibliography is unfortunately not complete. The author seems not to know the book of Talcott Parsons on the structure of social action or the articles of Parsons that were published in earlier years. They are the most important American contribution to the knowledge and the development of Weber's ideas.

ALBERT SALOMON

FANFANI, AMINTORE. *Saggi di Storia Economica Italiana*. [Publication of the Università Cattolica del Sacro Cuore, Series 3, Scienze Sociali, vol. 16.] Milan: Società Editrice "Vita e Pensiero." 1936. 302 pp. L. 18.

The author of this book is a learned scholar in the field of Italian economic history. His two books *Le Origini dello Spirito Capitalista in Italia* (1933) and *Cattolicesimo, Protestantismo e Capitalismo* (1934, translated into English in 1935) cannot be ignored by any student of European economic history in the last centuries of the Middle Ages

and in the first centuries of the modern age, though his Roman Catholic bias has led him in some instances to questionable interpretations.

He has collected in this volume eight essays on the most disparate subjects, ranging from the costs and profits of a thirteenth century merchant to the problems of labor in Italy during the last three decades of the nineteenth century. Some essays arouse a particular interest because, even if they do not solve the problems which they set themselves, they call attention to those problems and show the method to be followed if they are to be solved. The study of the accounts of the Aretine merchant, Lazzaro Bracci, in the fourteenth century leads the author to discuss the question of how customs duties and costs of transportation affected the price of imported merchandise. His documents point to the conclusion that those costs were much more moderate than one would expect. The data assembled on the population problem in the Duchy of Milan from 1386 to 1535 show that statesmen of the twentieth century have made no advance in intelligent handling of this matter. The essay on the mining industry in Lombardy under Spanish rule

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The most interesting essay is that regarding "The Problems of Labor in Italy from 1870 to 1900." On this subject the author gives a well informed and well written account which will be new to those unfamiliar with the history of the labor movement in Italy. It is a pity that he has excluded from his study the Christian Democratic movement which was so intense in the last decade of the nineteenth century. He states that lack of time kept him from treating this phase of his subject (p. 297), but he did not need to issue his book before he had described such an essential aspect of his theme. To lack of time should be added, perhaps, another and different reason. A fair-minded account of the Italian Christian Democratic movement would not be welcome, in the era of Pope Pius XI, in a book that was to be published by the Catholic University of Milan.

GAETANO SALVEMINI

Harvard University

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